

RISKINSIGHTS

2022

A D&O Market in Transition

The D&O liability environment is constantly changing, but 2021 was a particularly eventful year with important consequences for the D&O insurance market. The past year's developments have significant implications for what may lie ahead in 2022, and possibly for years to come. This edition of RT ProExec Insights discusses several events that occurred in 2021 and their future potential implications.

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Securities filings declined in 2021 relative to recent elevated years, returning closer to longterm levels

The number of federal court securities class action lawsuits filed during 2021 declined significantly compared to 2020, and was sharply below the elevated number of securities suits filed each year during the 2017-2019 period. However, the number of 2021 filings were above longer-term historical annual filing levels prior to 2017.

According to our count, there were 211 federal securities class action lawsuits filed in 2021, representing a 34% decline from the 320 federal securities suit filings in 2020, and about a 48% decline compared to the annual average number of lawsuits (405) filed during the 2017 - 2019 period—a period during which the number of securities lawsuits had surged. These figures reflect only securities class action lawsuit filings in the federal courts; the filing numbers do not include securities class action lawsuits filed in state courts in 2021.

The most significant factor in the decline in the number of filings in 2021 was the decline in the number of federal merger objection class action lawsuits. By our count, there were only 18 federal merger objection class action lawsuits during 2021, compared to 102 in 2020. The 2021 merger objection lawsuit filings represented an even sharper decline compared to the 2017-2019 period, where there were 160 merger objection filings in 2019, 182 in 2018, and 198 in 2017.

It is important to note that while plaintiffs' lawyers are still filing merger objection lawsuits, they are filing the lawsuits as individual actions, rather than as class actions. The threat of merger-related

litigation has not gone away, but the current form of the threat is not reflected in class action litigation statistics.

When merger objection lawsuits are excluded from the totals, the decline in securities suit filings during 2021, compared to 2020, is significantly less severe. Excluding merger objection suits, there were 193 "traditional" securities suit filings in 2021, representing only about an 11.3% decline from the 218 traditional filings in 2020.

Although the number of 2021 securities suit filings reflect a decline compared to 2020, as well as the years 2017-2019, the 2021 filing levels are much closer to historical filing rates. Indeed, the 211 securities suit filings in 2021 is actually above the annual average number of filings during the pre-surge years from 1997 to 2016, when an average of 193 securities class action lawsuits were filed each year.

There is a propensity to get stuck on the headline that 2021 securities class action lawsuits are down more than a third compared to 2020. However, when the merger objection litigation is removed, the relative declines in the number of filings are much more modest. The filing levels in 2021 appear to have simply returned to long-term historical levels, compared to the elevated levels that prevailed during the 2017-2020 period.

SPAC activity and SPAC-related litigation surged during the year

The amount of SPAC IPO activity in 2021 was nothing short of astonishing. According to SPACInsider, there were a total of 613 SPAC IPOs completed in 2021, raising total proceeds to \$162.4 billion. Both the number of SPAC IPOs and the amount of capital raised in 2021 far

exceed the then-record setting levels in 2020, when 248 SPAC IPOs raised \$83.3 billion. Given the volume of SPAC-related financial activity, there is now a greater likelihood of litigation activity.

There were a total of 31 federal SPAC-related securities class lawsuits filed in 2021. In addition to the securities lawsuits, there were also at least 14 SPAC-related derivative lawsuits filed. All of the derivative suits involved companies that were also hit with securities suits.

Beyond the securities and derivative suits, there were also other types of SPAC-related D&O lawsuits filed in 2021. For example, there were at least three state court direct action lawsuits filed which alleged fiduciary duty violations contending that the SPAC transactions should be assessed using the “entire fairness” standard. In addition, there were three lawsuits filed against SPACs alleging that the SPACs are in fact investment companies within the meaning of the Investment Companies Act of 1940, and that the companies had failed to register with the SEC as required by the ‘40 Act. Finally, there were also two SPAC-related SEC enforcement actions.

It is revealing that of the 31 SPAC-related securities lawsuits filed during 2021, only one involved a SPAC that completed its IPO in 2021. All of the other 2021 SPAC-related securities suits involved SPACs from the IPO classes of 2020 or prior. In other words, there is a lag between the time of the SPAC IPO and the time when the lawsuits begin to emerge. This certainly reinforces the likelihood that there will be a future surge of suits involving SPACs from the record-setting SPAC IPO classes of 2020 and 2021.

While many SPAC-related securities lawsuits were filed in 2021, few of the cases have reached the motion to dismiss stage. There is relatively little historical track record for these kinds of cases, and it remains to be seen how these lawsuits will fare. There was one settlement in 2021

of a SPAC-related lawsuit from an earlier era relating to Akazoo, a music streaming company that had merged with a SPAC in January 2019. The SPAC itself conducted its IPO in 2017. The company was hit with a securities class action lawsuit in April 2020 and reached a partial settlement of \$35 million in April 2021.

Further, the SEC has signaled to investors and the marketplace that it is focused on SPACs. In recent remarks, Gary Gensler, Chairman of the SEC, underscored the agency’s concerns with many SPAC transactions. In addition, during 2021, the SEC initiated two SPAC-related enforcement actions.

On July 13, 2021, the agency filed administrative charges against a SPAC called Stable Road Acquisition Corp., the SPAC’s CEO, and its proposed merger target, Momentus (an early-stage space travel company). The agency separately filed a civil enforcement action against Momentus’s CEO. The agency alleged that the defendants had falsely stated that the target company’s rocket system had been successfully tested in space. The SPAC and SPAC CEO were also charged for inadequate due diligence in connection with the proposed merger.

The SEC filed a second SPAC-related enforcement action in late July 2021, in conjunction with the presentation of a criminal indictment against Trever Milton, the founder of the electric vehicle company, Nikola. The SEC filed parallel enforcement charges against Milton. Many of the allegations in the SEC enforcement action are also alleged in a separate securities class action lawsuit that was filed against Nikola in September 2020. In addition, in December 2021, the SEC instituted a proceeding against Nikola itself.

As a general matter, most of the SPAC-related securities lawsuits have been filed a short time after the merger was completed (or, in a few cases, shortly after the merger was announced). In other

words, the SPAC lifecycle events that give rise to the possibility of a securities suit are primarily the SPAC's announcement of, and completion of, its business combination with a target company.

According to SPACInsider, as of December 31, 2021, there were 575 SPACs seeking to identify merger targets. In short, over the next 12-24 months, it is possible that a material number of SPACs will be going through the SPAC lifecycle events that historically have given rise to SPAC-related litigation risk. Historically, very few SPACs liquidate for lack of finding a target (there have been only 27 SPAC liquidations in total since 2009). In light of the hundreds of SPAC mergers that will likely be taking place over the next 24 months, it is probable that a certain number of the SPACs (or, more likely, the post-SPAC-merger companies) are going to be hit with securities suits.

In all likelihood, SPACs will remain in the spotlight, garnering scrutiny and potential litigation in 2022 and beyond.

COVID-19-related litigation continued to rise in 2021

Between March 1, 2020 and December 31, 2021, 42 pandemic-related federal securities class action lawsuits were filed. Of these, 24 were filed in 2020, and 18 were filed in 2021. There have also been at least 16 pandemic-related shareholder derivative lawsuits, of which nine were filed in 2021. In addition, there have also been at least ten pandemic-related SEC enforcement actions.

Until the latter half of 2021, pandemic-related securities class action lawsuits generally fell into one of three categories:

1. Claims against companies that experienced coronavirus outbreaks in their facilities (cruise ship lines, private prison systems, meat-packing plants).

2. Claims against companies that claimed to be in a position to profit from the coronavirus outbreak (vaccine development companies, diagnostic testing companies, online learning platforms).
3. Companies that experienced disruption in their operations or financial results due to the coronavirus outbreak (hospital systems, real estate development companies).

The plaintiffs' track record in the above categories has largely been poor. In the final months of 2021, a fourth category of pandemic-related securities suits emerged. The lawsuits in this fourth category were filed against companies that had prospered at the outset of the pandemic, but then experienced their fortunes ebbing as government shut-down orders were withdrawn and businesses reopened.

An example of one of these "fourth category" lawsuits is the securities class action suit filed in November 2021 against the exercise equipment company, Peloton Interactive. It has been alleged that the company's revenues soared at the outset of the pandemic as homebound consumers drove high demand for the company's exercise equipment. The company ramped up its inventory, while purportedly assuring investors that its pandemic-related growth was sustainable. The company's share price later declined after the company announced weaknesses in its financial controls relating to its inventory levels.

Other companies that were sued in one of these fourth category lawsuits include the web meeting hosting platform, ON24. ON24 had also experienced an early surge in demand at the outset of the pandemic, followed by a later decline. Similarly, the consumer product company, The Honest Company, experienced an early pandemic-related spike in sales of its health and hygiene products, followed by a later slump. Other examples include the

technology company, Citrix Systems, and in late December, there were additional fourth category lawsuits filed against DocuSign and Chegg.

It seems likely that fourth category lawsuits might continue to be filed in the weeks and months ahead. Future cases may also arise from second-level effects of the pandemic, such as supply chain disruption, labor shortages, and economic inflation, as discussed below.

Pandemic-related effects roiling the economy, increasing the risk of further litigation

As we head into 2022, there are at least three threats that could potentially bear down on the economy and could have a big impact in the months ahead. These threats are, at least in part, follow-on effects from the pandemic, although they are not exclusively so. These threats are: supply-chain disruption, labor shortages, and economic inflation. These threats not only have implications for the domestic and global economies, but they also have litigation implications which have already been manifested in several lawsuits discussed below.

For example, ATI Physical Therapy, a national chain of physical therapy clinics, was sued in August 2021 (shortly after the company merged with a SPAC), after the company announced that it was experiencing higher than expected attrition of its staff of physical therapists and encountering increased competition for replacement staff, resulting in higher labor costs and operating disruptions.

Similarly, Romeo Power, which manufactures batteries for electric vehicles, was sued in April 2021, (shortly after the

company merged with a SPAC), after the company announced that its production had been hampered due to disruptions in the supply of an important component part.

In December 2021, the bedding and mattress company, Sleep Number, was targeted by plaintiffs in a securities class action lawsuit relating to the company's disclosures about the extent of the disruption to its mattress foam supply, caused by the Texas winter storms.

Some economists and politicians believe that these current economic factors will prove temporary. Eventually and hopefully, the supply chain constraints will ease and labor market disruptions will abate, which, in turn, could alleviate inflationary pressures. However, the Omicron variant outbreak in the final weeks of 2021 could cause even further disruptions and could further delay the return to stability and normalcy.

Even if these various economic factors prove to be temporary, they are still likely to affect companies in the short term, which could create both operating and litigation risk for many companies. The larger concern is what might happen if these economic factors prove to be more enduring. Many of these issues are going to unfold during 2022, with potentially serious implications.

For now, the D&O insurance industry remains in the hard market

Insurance is a cyclical business. For many years, the D&O insurance industry was in a sustained "soft market," characterized by abundant insurance capacity, low pricing, and broad coverage. More recently, the industry has been in a "hard market" phase. Pricing for D&O insurance

began to rise in late 2018. After years of underpricing and adverse claims development, insurers generally began seeking higher premiums. The increases accelerated in 2019 and were further exacerbated by the coronavirus outbreak in 2020. Pricing increases continued through 2021, although the magnitude of price increases for some buyers began to decelerate during the year. The hard market has been characterized not only by higher prices, but also by reduced capacity (as many insurers seek to reduce their exposed limits) and oftentimes increased retentions.

As part of the process that makes insurance a cyclical business, the higher pricing levels have attracted new insurers. There are an increasing number of new D&O insurers domestically, as well as in London and Bermuda. Many of these newer players are up and running, which means that additional capacity is available, at least for some buyers. Eventually, this new capacity is likely to lead to increased competition, which in turn could cause the cycle to move into the next phase and begin to become more favorable to insureds to some degree. To a certain extent, these processes are already evident, at least with respect to high attachment excess D&O insurance, where rates have started to ease for some buyers.

As we head into 2022, the overall D&O insurance market remains hard, with most buyers receiving renewal quotations with premiums at the elevated levels which

had been set over the past four years. For certain buyers, such as IPO companies, SPACs, de-SPAC companies, and financially troubled companies, pricing remains at distressed levels. The likelihood is that the current hard market conditions will remain in effect at least through the first half of 2022.

Closing Comments

There were many more developments in 2021 that may have significant implications for the D&O marketplace in 2022, such as:

1. Cybersecurity-related D&O claims
2. Board diversity concerns triggering legislation, regulation, and litigation
3. Sexual misconduct or harassment-related D&O claims
4. Recent successes in breach of duty of oversight claims

We would welcome the opportunity to discuss any of the above items with you in further detail. In the meantime, given the disrupted market conditions, retail agents and brokers can benefit from the assistance of an experienced and knowledgeable wholesale broker for their D&O insurance placements. This is a time when specialized D&O insurance expertise and deep knowledge of the insurance market are indispensable.

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