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RISKINSIGHTS

FALL 2022

What to Watch in the World of D&O

Securities Class Action Lawsuits

Based on the filings for the first eight months of the year, it appears that the projected number of year-end 2022 filings will likely track closer to last year's lower numbers rather than the elevated numbers that prevailed during the period 2017- 2019 (there were over 400 filings each year during that period, largely due to an increased number of federal court merger objection lawsuit filings). As of August 31, 2022, there have been approximately 137 federal court securities class action lawsuit filings, which projects to roughly 206 federal court securities class action lawsuit filings by year-end. An annual total of 206 securities lawsuits would be slightly below the 211 federal court securities class action lawsuits filed in 2021, and well below the 319 federal court securities class action lawsuit filings in 2020.

The public D&O marketplace has continued its pace of rapid change over the past twelve months. As the following discussion illustrates, there is currently much to watch in the world of D&O.

The projected level of filings would represent the third straight year with a decline in the number of federal court securities class action lawsuits. Again, the decline in securities class action lawsuit filings is, in our view, largely due to a shift in plaintiffs' lawyers' tactics with respect to merger objection lawsuits; increasingly, plaintiffs' lawyers are filing these suits as individual actions rather than as class actions.

Because of the potentially distorting impact of merger objection litigation filings on the overall filing numbers, observers sometimes exclude the merger suits from the analysis and focus solely on "traditional" or "core" filings (that is, damage actions under Section 10 of the '34 Act and under Section 11 of the '33 Act). The 2022 filing levels look slightly different when only core filings are considered.

Of the 137 federal court securities suits filed in the year's first eight months, 132 were core filings. This level of core filing activity implies a year-end total of core filings of 198, which would actually be slightly above the 192 core federal court securities class action lawsuit filings in 2021, although somewhat below the 234 core filings in 2020. Overall, the general sense is that securities suit filings YTD 2022 are roughly in line with the 2021 filing levels.

SPAC-Related Litigation

By our count, there have been a total of 50 SPACrelated securities class action lawsuits filed since January 1, 2021, with at least 19 so far in 2022 (through August 31, 2022). The 19 SPAC-related securities suits represent about 14% of all YTD 2022 federal court securities class action lawsuit filings. Several significant factors have driven this litigation. For example, 20 of 50 (or 40%) of the cases so far have been filed after the defendant company's share price declined following the publication of a short seller report. In addition, 17 of 50 cases (or 34%) have involved companies in the electric vehicle space.

Although some of the SPAC-related litigation has arisen prior to the completion of the SPAC's merger with a private company, the merger has generally been the SPAC life-cycle event that triggered many of the SPAC-related securities suits. According to SPACInsider, there are nearly 570 SPACs currently searching for acquisition targets. As such, there are likely to be many more SPAC-related mergers in the months ahead, which means that there are likely to be further SPACrelated suits ahead.

However, there have been a number of developments in recent months that have affected the SPAC financial marketplace, and that could affect the level of SPAC-related litigation. For starters, the marketplace for SPAC IPOs has cooled. A likely factor driving the decline in SPAC IPOs is the SEC's introduction of proposed SPACrelated guidelines in March of 2022, which would eliminate most of the perceived advantages of SPACs over traditional IPOs.

Another issue affecting the SPAC market is the sheer number of SPACs seeking merger partners. A number of planned SPAC mergers have been called-off before the business combination has been completed. Stories are already circulating in the financial press regarding the possibility that many of the searching SPACs may

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be unable to identify suitable merger partners. This being the case, there is a likelihood that SPACs may find liquidation to be their best option—and it begs the question if the option to liquidate will lead to litigation.

Another possibility is that SPACs struggling to complete a merger, may push to complete any deal, even if it is disadvantageous or the target is far outside the SPAC's intended sector. There has already been at least one lawsuit in which the plaintiffs alleged that the SPAC's executives, motivated by the personal financial interest in completing a deal, chose to merge with a company far outside the stated target sector. There could be more of this type of litigation as SPACs push to complete deals as the end of their search periods approach.

As for how these SPAC-related cases will fare, it is too early to tell. Relatively few of the various SPAC-related securities suits have reached the motion to dismiss stage. For the few cases that have reached the dismissal stage, the results are mixed.

COVID-19 Related Securities Class Action Litigation

The COVID-19 pandemic is now well into its third year. From the very beginning of the coronavirus outbreak in the U.S., the pandemic has been accompanied by a significant volume of securities class action litigation activity. Just as the pandemic continues to represent a health threat, the ongoing pandemic has also continued to generate COVID-19-related securities litigation. By our count, there have been a total of 57

CATEGORIES OF COVID-19 RELATED SECURITIES SUITS

By our assessment, the COVID-19-related securities suits generally fell into one of three categories:

1. Lawsuits against companies that experienced coronavirus outbreaks in their facilities (e.g., cruise ship lines, private prison systems);
2. Lawsuits against companies that tried to establish that they would prosper as a result of the pandemic (e.g., diagnostic testing companies, vaccine developers);
3. Lawsuits involving companies that experienced a downturn in their business operations or financial results as a result of the pandemic (e.g., hospital systems, real estate developers).

More recently, a fourth category of cases has emerged. These cases involve companies that prospered at the outset of the pandemic but whose fortunes waned as the conditions resulting from the pandemic evolved. A high-profile example of a case of this type is the lawsuit filed in July 2022 against Amazon. It is alleged in the complaint that, in response to huge spikes in internet commerce at the outset of the pandemic, Amazon ramped up its distribution infrastructure, saying at the time that the infrastructure investment was justified because of what were believed to be permanent changes in consumer buying habits. However, the plaintiffs allege that as the pandemic evolved, many consumers returned to prior buying patterns, leaving Amazon with infrastructure overcapacity.

Considering the continuing evolution of the pandemic and its uncertain impacts on commerce, we might see more of these kinds of "fourth category" cases in the months ahead.

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coronavirus-related securities class action lawsuits filed since the initial coronavirus outbreak in March 2020, including 14 so far in 2022.

The results for the plaintiffs in these cases have been mixed. Many of these cases have not yet reached the motion to dismiss stage. Two of the cases that survived dismissal motions have now been settled. In August, Inovio Pharmaceuticals announced that it had reached an agreement to settle the COVID-19-related securities suit that had been filed against the company for cash and stock totaling $44 million. Also in August, Vaxart announced that it had agreed to settle the COVID-19 related securities suit pending against the company for $12 million.

Just as the coronavirus itself has proven to be persistent, the related litigation phenomenon has proven to be persistent as well. Not only have plaintiffs continued to file COVID-19 related securities class action lawsuits this year, but there were three of these cases filed in August alone. All signs are that these kinds of lawsuits might continue to be filed as the year progresses.

Current Macroeconomic Challenges May Lead to Corporate and Securities Litigation

Companies currently face a daunting array of macroeconomic challenges—rampant inflation, rising interest rates, supply chain disruptions, labor supply challenges, the war in Ukraine, and even the continuing disruptive impact of the pandemic. These various challenges will almost certainly affect the business operations and financial results of many companies. These factors may also contribute to litigation risk.

A lawsuit filed in June 2022 against the consumer products company Tupperware illustrates the way in which these various macro factors can translate into securities litigation. During the company's execution of a multi-year turnaround plan, the company had touted its successful plan execution and projected expansion. However, in a May 2022 earnings release, the company reported results that were "below expectations" and that the company was withdrawing its year-end earning guidance. The company cited several factors in connection with the disappointing results, including the war in Ukraine and COVID-related lockdowns in China. The company also said that its profitability was "significantly impacted by persistent inflationary pressures and the latency between rising input costs and our decision to increase prices."

Another lawsuit, filed in March 2022, illustrates how the impact of economic inflation can translate into securities litigation. Vertiv, a company that makes data storage and transmission products, reported disappointing results in its year-end 2021 earnings release. In explaining the results, the company's CEO attributed the disappointing results to management "consistently underestimating inflation and supply chain constraints for both time and degree, which dictated a tepid 2021 pricing response." The company's CFO said "We significantly underestimated the magnitude of material and freight inflation in the fourth quarter forecast, mostly in America, by approximately $36 million."

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Other recent securities suit filings illustrate how supply chain disruption can lead to securities litigation. For example, the software company Cerence was hit with a securities suit when it announced disappointing results after the company experienced a reduction in automobile industry demand for its products and services due to the global semiconductor shortage.

As these examples show, a variety of macroeconomic factors threaten to disrupt many companies' business operations and financial results, which in turn could affect the companies' share prices. These macroeconomic factors seem likely to persist in the coming months. The disclosure statements of companies experiencing a negative impact from these factors are likely to be closely scrutinized. In some cases, the scrutiny may lead to securities litigation.

ESG Potential Impact on D&O Risk

ESG-related issues dominate much of the current conversation about business and litigation risk. There has been speculation in the financial press that activist groups would initiate litigation against companies that have been deemed to be ESG laggards. In actuality, the cases being filed are targeting companies that have been proactive on ESG matters—and have had execution issues on their ESG promises, fallen short of established goals, or become mired in controversy because of the companies' ESG positions. For example, a securities class action lawsuit was filed against Wells Fargo related to adverse publicity that followed revelations about the company's poor execution of its diversity, equity, and inclusion initiative.

By the same token, the SEC's ESG Task Force has filed enforcement actions relating to, for example, a company's assertions in its sustainability statement about its mining dam safety and an investment fund's claims about its "green" investing options. Further, what could be seen as an anti-ESG backlash has now developed. For instance, as many as 17 states have adopted or proposed anti-ESG legislation. This legislation limits the ability of state governments, including public retirement plans, to do business with entities "boycotting" industries based on ESG criteria or considering ESG factors in their investment processes.

The emergence of the anti-ESG backlash further complicates the circumstances for companies as they grapple with decisions regarding how best, if at all, to address ESG-related issues.

Cybersecurity-Related Securities Claims

One of the continuing D&O litigation trends over the last several years has been the incidence of securities class action lawsuits and other litigation arising out of cybersecurity incidents. While in many instances these suits have not fared well, plaintiffs' lawyers have nevertheless continued to file the suits.

For example, in February 2022, secure technology company Telos Corporation was hit with a securities suit following a decline in the price of its shares after the company

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experienced revenue delays owing to cybersecurity and coronavirus-related "headwinds" that postponed the company's performance of two key contracts. Similarly, on May 20, 2022, a plaintiff shareholder filed a securities suit against the cybersecurity firm Octa, Inc., relating to the decline in the company's share price following revelations of a data breach at the firm.

The interest of plaintiffs' lawyers in pursuing cybersecurity-related securities suits may have been boosted by the March 2022 ruling in the cybersecurity-related securities suits pending against the cyber technology firm SolarWinds. The federal judge presiding over the SolarWinds cybersecurity-related securities suits substantially denied the defendants' motions to dismiss. At a minimum, the court's ruling shows that in some circumstances, plaintiffs can assert cybersecurityrelated D&O claims sufficient to survive a motion to dismiss. In addition to the securities class action claims, SolarWinds' board of directors was also sued in a Delaware state court derivative action for its alleged breach of the duty of oversight of the company's cybersecurity risks. On September 6, 2022, the Delaware court granted the defendants' motion to dismiss. This dismissal is not particularly instructive on the merits of this particular case as breach of oversight claims are one of the most difficult actions for a plaintiff to sustain.

On the other hand, and notwithstanding the outcome of the dismissal motion in the SolarWinds case, the overall record for the plaintiffs in cybersecurity-related securities suits is not particularly good. For example, in March 2022, the Ninth Circuit affirmed the dismissal of the cybersecurity related securities suit that had been filed against Zendesk. In April 2022, the Fourth Circuit affirmed the dismissal of the high-profile data breach-related securities suit that had been filed against Marriott. More recently, on September 13, 2022, the Capital One data breach-related securities suit was dismissed. Interestingly, in this particular case, while the Eastern District of Virginia judge Anthony J. Trenga's opinion found that the plaintiff had failed to present sufficient allegations of scienter in order to establish a claim for breach of the securities laws, he did say that plaintiff's claims may have been sufficient to establish claims of mismanagement. This does raise the question of whether the plaintiff might have been able to assert viable claims on a theory other than securities law violations. There would of course be threshold defenses even against a mismanagement claim, but it does raise the question whether a different legal approach might have been more successful.

Plaintiffs' lawyers may not be as focused on the mixed record on motions to dismiss as they are on the possibility of making a big score in one of these cases. The $149 million settlement in the Equifax cybersecurity-related securities lawsuit certainly provides enough incentive for plaintiffs to pursue these kinds of claims. The likelihood is that notwithstanding the plaintiffs' relatively poor record in these cases, cybersecurity-related D&O claims will continue to be filed.

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SEC'S PROPOSED CYBERSECURITY DISCLOSURE GUIDELINES

One important development worth watching in connection with this issue is the SEC's pending action on the agency's proposed cybersecurity disclosure guidelines. The guidelines, which the agency proposed in March 2022, include both incident reporting guidelines and risk management and governance disclosure guidelines. Agency action on the proposed guidelines is expected before year end. The agency's guidelines will impose additional reporting and disclosure requirements. The requirements included in the current proposal, like many disclosure obligations, could create significant new litigation risk for companies whose disclosures fall short of the requirements or whose actual cybersecurity experience differs from circumstances described in the company's cybersecurity disclosures.

The D&O Insurance Market

From late 2018 through the end of 2021, the D&O insurance marketplace was in a so-called "hard" market, meaning that most buyers saw their D&O insurance premiums increase significantly. Some D&O insurance risks were "hard to place," meaning that the insurance came at a very high cost and subject to very large, self-insured retentions.

The hard market conditions persisted for a considerable amount of time, but insurance is a cyclical business, and it was inevitable that the market would eventually move on to the next phase of the cycle. In the first half of 2022, signs emerged in the marketplace that the shift had begun. Generally speaking, the easing was initially applicable to high attachment excess placements, but as the year progressed, the easing has spread to all layers of public company D&O programs.

At least two things are contributing to this shift. The first is that the elevated pricing during the hard market phase attracted new capacity to the marketplace. Initially, the new players' presence did not impact the market, but as they have scrambled for business, competition has returned to the placement process. The second factor is that the drop-off in IPO activity means that there is less new public company D&O business available. Insurers are now vying for each other's business.

The result for many buyers is that, at least for now, the D&O insurance pricing environment has improved. Many buyers will see their overall public company D&O insurance costs decrease at their next renewal (largely dependent on the company's risk factors and particular circumstances).

When it comes to the insurance cycle, the hardest part is predicting what may be coming next. The adverse financial circumstances discussed above could have a dramatic impact on the business environment and there is a risk that the economy could slip into a recession. If that happens, it would impact the insurance marketplace and could move the D&O market back into a hardening market phase. As mentioned at the outset, there is a lot to watch these days in the world of D&O.

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