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3 D&O Questions Regarding Event-Driven Securities Litigation

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Last month, a shareholder of Edison, the public utility company blamed for starting or contributing to the recent wildfires in Southern California, filed a securities class action complaint alleging that Edison failed to disclose that its electricity transmission and distribution networks were noncompliant with state law and that the noncompliant electricity network created a significant risk of wildfires in California. In the recent expert analysis, Examining A Post-Wildfire Securities Suit, Kevin LaCroix of RT ProExec discussed this so-called "event-driven securities litigation," a new kind of securities class action that relies on specific adverse events, rather than fraudulent financial disclosures or accounting issues, as the catalyst for targeting both companies and their directors and officers for the resulting drop in stock price.

The article touches on the significant problem this new kind of securities litigation may cause for public company directors and officers insurance underwriters, but policyholders and other insurance industry participants should also take note of these developments. Below are three questions corporate policyholders should consider when evaluating the availability of D&O coverage for event-driven securities litigation, the implications that the rise in such litigation are likely to have on their existing D&O insurance and how event-driven lawsuits are likely to shape the future of D&O insurance.

1. Am I Covered?

When it comes to event-driven securities claims, as with most insurance exposures, perhaps the first questions on the minds of corporate policyholders and insurance managers are "am I covered" and if so, for what? Of course, any coverage determination will depend ultimately on the specific policy language at issue, but thankfully for policyholders, D&O coverage is typically broad for securities-type claims like those precipitated by the California wildfires and other event-driven lawsuits against directors and officers. D&O forms typically provide coverage for the individual directors and officers named in their individual capacities (referred to as "Side A" coverage), amounts paid by the company to indemnify its directors and officers (Side B coverage), and "Securities Claims" brought directly against the company (Side C or "entity" coverage).

The lawsuit must allege a "wrongful act" by the company or its directors and officers, which in most instances will be satisfied by allegations of securities violations, fraud and breach of fiduciary duty. The

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coverage question turns largely on the type of claim (securities violations) and alleged harm (decrease in stock price), which exist in both traditional securities class actions and event-driven securities lawsuits. In the recent Edison lawsuit, for example, the plaintiff alleged harm from the precipitous decline in market value of Edison securities after the wildfires as a result of Edison's alleged false and misleading statements and failure to disclose facts about the company's business, operational and compliance policies.

Furthermore, the attorneys' fees and other defense costs incurred in litigating securities claims should also be covered, regardless of whether the D&O policy affords a duty to defend (where the insurer defends and controls the suit) or a duty to reimburse (where the policyholder retains defense counsel and is reimbursed by the insurer for defense costs). The insurer's obligation to pay these defense costs — which can be substantial and at times even exceed the amount of settlement — is much broader and requires only that the allegations raise a potential for coverage. Thus, even though they diverge in several respects from the typical securities claim model, event-driven lawsuits nevertheless raise a potential for coverage because they still involve the requisite investor harm tied to alleged wrongful acts by the company and its directors and officers, which D&O insurance is written to protect.

Coverage for judgments and settlements, in contrast, turns on the underlying facts and whether there is, in fact, coverage for the particular claims alleged in the lawsuit. For example, securities claims or tort claims alleging intentional conduct or arising from pollution may be subject to policy exclusions for those claims depending on the particular policy language at issue. But even in clear instances of excluded claims, there can still be substantial recovery of defense costs if another claim is covered or if the exclusion requires a final adjudication of the issue.

This is especially important in securities litigation because those claims typically require some proof of scienter on the company's part in misleading shareholders or failing to disclose pertinent information that led to the drop in stock price. Even though most D&O policies include an exclusion prohibiting dishonest or knowing conduct, many policies now contain favorable language triggering the exclusion only upon a final determination of intentional or knowing conduct. Carefully reviewing all policy insuring agreements and exclusions is crucial to identify these issues and ensure that the company can recover significant defense costs prior to a final adjudication.

In sum, event-driven securities litigation should be subject to the same coverage claims and defenses as traditional securities litigation and, as mentioned in the prior article, poses more of a problem for public company directors and officers insurance underwriters in understanding the risk than for the companies they insure.

2. Why Does This Matter?

Even if the potential coverage requirements and insurer defenses are largely unchanged, event-driven securities litigation is significant for several reasons. First, as event-driven claims become more prevalent, their volume alone may impact the D&O insurance market and the insurability of corporate policyholders. Indeed, the sheer number of securities litigations, whether event-driven or otherwise, impacts limits, loss history and other aspects of insurance that affect both underwriters and policyholders alike.

Second, the nature of the "event" giving rise to the event-driven securities claims is different from traditional securities class actions involving a merger or other corporate transaction — the events are

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often national and even international news, which leads to additional public scrutiny even before the securities lawsuit is filed. In fact, the newsworthy event often provides the impetus for the event-driven claim, since it is the publicity of the event itself that allegedly causes the purported adverse impact on the value of the company's shares. It is no wonder, therefore, that a common feature of event-driven securities lawsuits is citation to media reports as part of an effort to tie the company and its directors to the damaging event. Given this significant media and public relations component, policyholders may consider obtaining public relations-type coverage, either through endorsement or as part of a management liability policy. Crisis response and similar first-party media coverages may provide resources to respond to plaintiffs' public relations campaigns.

A third characteristic of event-driven claims is the increased potential for claims against related corporate entities. This was the case with the Edison lawsuit. The Edison shareholder targeted not only Edison, but also the subsidiary that managed the power station that supposedly sparked the fire. Significantly, the plaintiff did not own shares of the subsidiary. Traditionally, securities class actions are brought against the entity in which the plaintiff owns shares, based on alleged misrepresentations in the company's financial disclosures. In the case of event-driven litigation, however, plaintiffs may assert claims against separate but related corporate entities if the related entity's operations are involved in the allegedly injurious event. Despite naming these additional corporate defendants, the plaintiff in the Edison case only alleged violations of the Securities Exchange Act of 1934, not standalone breach of fiduciary duty, negligence or misrepresentation claims. This is significant from a coverage perspective because it is tort-based claims that typically trigger an insurer's duty to defend or to reimburse defense costs. In contrast, allegations that are directed at "Securities Claims" may implicate exclusions for fines and penalties or knowing and willful conduct.

Notwithstanding the viability of these claims, the expanded scope of putative defendants (even at the complaint stage) underscores the importance of ensuring adequate coverage for all pertinent entities and individuals that may be targets (e.g., parent companies, subsidiaries, affiliates, former directors), especially after mergers, acquisitions and other transactions. Engaging in regular insurance audits can help mitigate these risks.

3. What's Next, and Will There Be Coverage?

Event-driven securities litigation, by its nature, is inherently unpredictable because the triggering events (like wildfires) are not entirely foreseeable and largely beyond the range of traditional corporate risk management efforts, especially when compared to traditional merger challenge or similar securities lawsuits. Precipitous drops in stock prices are not uncommon, and given this new risk of follow-on securities litigation, it is difficult to predict what events may lead to future lawsuits. That said, there are high-profile developments nationally and internationally that are more likely to result in a securities-related insurance claim, such as enhanced privacy regulation under the EU's new General Data Protection Regulation and increasing scrutiny given to "Me Too" allegations in the workplace, both of which have already led to securities litigation.[1]

Future data breaches, workplace misconduct, and similarly adverse events (products liability, environmental disasters, public corruption, etc.) could lead to additional suits. Having a robust D&O program is critical to mitigating any increased exposure, which may require expanded coverage tailored to a company's particular risks, including excess or even standalone "Side A" coverage to protect individual officers and directors.

Notes

[1] See, e.g., Facebook Inc. *Kacouris v. Facebook Inc., et al.*, No. 1:18-cv-06765 (S.D.N.Y. filed Jul. 27, 2018) (shareholder suit against Facebook related to the company's alleged misleading statements about or failure to disclose impact of GDPR and related privacy issues); Wynn Resorts Ltd. *Ferris v. Wynn Resorts Ltd., et al.*, No. 1:18-cv-01549-DLC (S.D.N.Y. filed Feb. 20, 2018) (shareholder suit against Wynn Resorts regarding company's failure to disclose CEO's alleged sexual misconduct).

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