

FINEX D&O Observer

Fall 2019

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Welcome to the Fall 2019 edition of the FINEX D&O Observer.

Our Financial, Executive & Professional Risk Practice ("FINEX") at Willis Towers Watson, twice each year compiles content authored by team members throughout our practice for our FINEX D&O Observer. In this, our D&O edition, as in previous editions, we also feature a guest author offering important perspectives from outside the insurance brokerage community.

In the pages that follow, we discuss the phenomenon of excess D&O pricing outpacing primary rate increases. We also dive into coverage for civil investigative demands and how differences in policy language can have a bearing on recovery for these potentially costly matters. Our guest author, John D. Shugrue of Reed Smith LLP, examines how broadening definitions of the term "Claim," a practice designed to enhance coverage, may have unintended consequences. Recognizing that for some risk professionals, a hardening D&O market is uncharted territory, we then discuss how to make sense of the market and how organizations can mitigate against the market's impact. Finally, we examine Securities and Exchange Commission enforcement authorities, and how they are not merely a public company concern. Simply put, private companies are subject to SEC oversight as well.

The articles included in the FINEX Observer series also can be accessed at our Willis Towers Watson Insights [webpage](#). Throughout the year, content is issued there, and we encourage you to bookmark and visit the site regularly to view the latest alerts, blog posts, articles, and white papers. We look forward to continuing the practice of showcasing our thought leadership here, as well, by compiling a selection of our regularly issued content on a bi-annual basis in the FINEX Observer series.



Excess D&O for public companies: No longer an afterthought

By Lisa Spiller

There has been much discussion and awareness of the firming of the public company directors and officers (D&O) liability insurance market. A relatively recent twist to this discussion is what is happening specifically in the excess D&O market. In Q2 of 2019, our proprietary rate trending analysis report depicted increases in the traditional excess D&O coverage outpacing primary rate increases. The trend widened in Q3. This is the first time in nearly 20 years we have seen this phenomenon occur.

Definitions

In discussing excess D&O insurance, some industry terminology is used and is important to understand. Rate per million (RPM) and rate-on-line (ROL) or increased limits factor (ILF) are key terms with corresponding acronyms frequently employed in reviewing programs.

Rate per million (RPM) = Premium for the layer (limit for the layer/\$1,000,000).

Example: A \$10,000,000 limit for \$100,000 premium is \$10,000 RPM.

Rate-on-line (ROL) = Percentage rate used to describe the RPM. In the above situation, the ROL is 10%.

Increased limit factor (ILF) = The RPM of the excess/RPM of the layer below.

Example: The primary premium for a \$10,000,000 limit is \$100,000, and the first excess \$10,000,000 limit excess \$10,000,000 limit is \$50,000. The primary RPM is \$10,000 and the first excess RPM is \$5,000. The ILF is \$5,000/\$10,000 = .50 or 50%. A way of stating this is the first excess is receiving 50% of the premium the primary is receiving on a RPM basis.

Note: Some industry professionals also refer to this as rate-on-line (ROL).

Attachment point = On a layered program, this is the combined value of the limit below where the respective insurance carrier begins its coverage. Keep in mind that retentions on the primary are generally not included in these calculations.

Example: The primary carrier has a \$10M limit, the first excess a \$10M limit, and the third excess a \$10M limit. The attachment point for the first excess is \$10M and the second excess is \$20M.

Background

Over the past 10-12 years, excess rates were decreasing year over year. A decade ago, a 70% or higher ILF for the first excess was very common. Fast forward to 2018 and we saw many insureds' first excess ILFs between 50% – 60%, and on rare occasions, some even going lower than 50%! The ILFs for the second excess and above continued to decline over time as well.

Many carriers were amending their stated minimum premiums at each renewal cycle as well. In 2007, excess of \$100M attachment point, any premium under a \$10,000 RPM was a huge success! Fast forward to 2017, and many carriers were quoting an excess RPM at MUCH lower attachment points for \$3,000 per million (or sometimes even less). Keep in mind, this was not just for Side A only coverage, but full, standard D&O coverage! Given the extreme and prolonged aggressiveness we experienced in the excess market, it was not uncommon for the end result of a D&O tower renewal to achieve a double-digit premium decrease after starting with a flat (no change) or even a small increase on the primary layer.

How was this achievable? Several factors came into play, but most notably was that supply outpaced demand and carriers were hungry to win business. There were many new entrants into the U.S. D&O market, some with recognized and respected names. Entering a D&O market as a new carrier, it is very challenging to be considered as a primary alternative. Newer entrants, therefore, often targeted excess capacity and were willing to quote well below expiring pricing. Incumbent and tenured carriers were fully aware of the market dynamic, most often did not want to lose the excess position on the tower, and were generally agreeable to lower pricing, sometimes quite dramatically in order to maintain their position on the account.

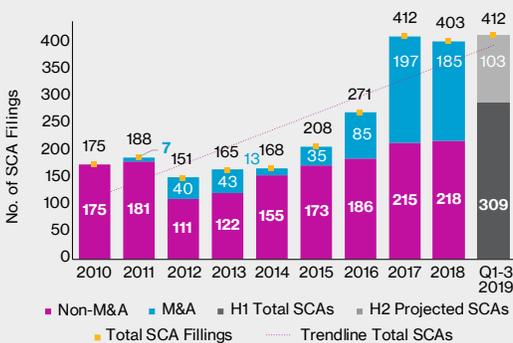
Today

What has changed in 2019 that excess D&O markets are now quoting rate increases in excess of primary increases? The insurance carriers' rationale:

1. Rates on the excess went down dramatically over the past decade – at a much larger percentage than the primary.
2. Loss ratios: Excess books (outside of Side A only) were performing worse from a loss ratio perspective than their primary books.
3. Frequency and severity of securities class action (SCA) claims are up (see graphs below). It is more likely for a company to be sued than in prior years, and the median and average settlement values suggest lower layer excess carriers are contributing to more settlements. Additionally, defense expenses are not part of these settlement figures, and defense expenses, which are covered under D&O insurance policies, can be quite significant.
4. The number of publicly traded companies is down significantly since 2000, so there are fewer comparable insureds paying D&O premium. There were 7,994 listed on U.S. exchanges in 2000 and 5,350 in 2018 (33% decrease).
5. Mega settlements (over \$100M) were up in 2018, and carriers believe there are more in the pipeline for 2019 and beyond. A \$100M settlement could very likely involve 8 – 12 carriers, with many or all carriers contributing their full limits of liability. Point to consider: Using a \$5,000 RPM, it takes 200 placements \$10,000,000 in capacity to equal a full \$10,000,000 loss.

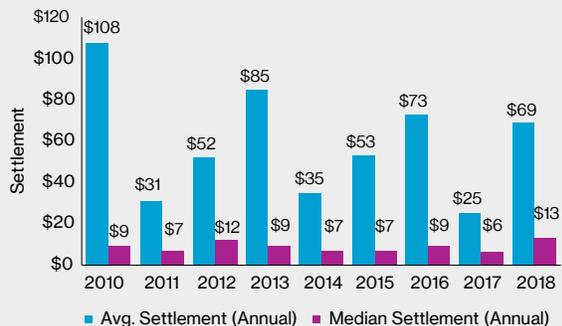
Filings

As of October 1, 2019



Settlements

As of January 2019, in a million USD



(Filings based on The Stanford Law School/Cornerstone's Securities Class Action Clearinghouse website and its Securities Class Action Filings: 2018 Year in Review. Settlements based on Nera's Recent Trends in Securities Class Action Litigation: 2018 Full-Year Review.)

Example

Below is an example of the current market dynamic. For ease of calculations, all layers are \$10M in capacity.

If Expiring ROLs are followed:

Product	Limit (M's)	Retention Attachment (M's)	2018 Premium	RPM	ROL/ILF	2019 Premium	RPM	ILF	RPM	ROL/ILF	\$ Change	\$ Change
D&O	\$10	\$1M	\$200,000	\$20,000		\$230,000	\$23,000		\$23,000		\$30,000	15%
D&O	\$10	xs \$10	\$100,000	\$10,000	0.500	\$115,000	\$11,500	0.500	\$11,500	0.500	\$15,000	15%
D&O	\$10	xs \$20	\$55,000	\$55,000	0.550	\$63,200	\$6,320	0.550	\$6,320	0.550	\$28,000	15%
Total through \$30M			\$355,000			\$408,200					\$53,200	15%

Example of increasing ROLs up the tower:

Product	Limit (M's)	Retention Attachment (M's)	2018 Premium	RPM	ROL/ILF	2019 Premium	RPM	ILF	RPM	ROL/ILF	\$ Change	\$ Change
D&O	\$10	\$1M	\$200,000	\$20,000		\$230,000	\$23,000		\$23,000		\$30,000	15%
D&O	\$10	xs \$10	\$100,000	\$10,000	0.500	\$138,000	\$13,800	0.600	\$11,500	0.600	\$38,000	38%
D&O	\$10	xs \$20	\$55,000	\$55,000	0.550	\$83,000	\$8,300	0.601	\$6,320	0.601	\$28,000	50.9%
Total through \$30M			\$355,000			\$451,000					\$96,000	27.04%

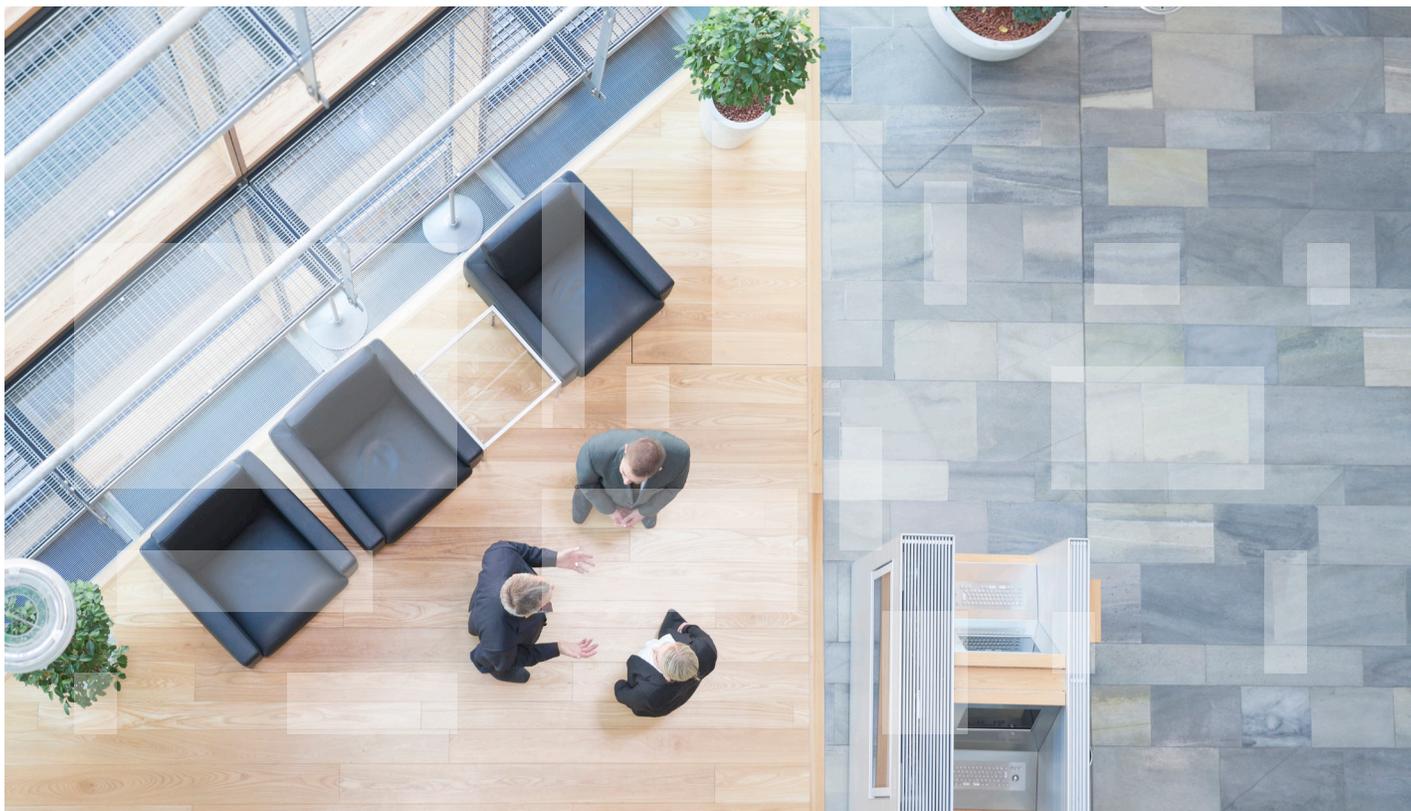
The expiring premium on the primary was expiring \$200,000, and the first excess was \$100,000. This is a 50% ILF. At the renewal, the primary achieved a 15% premium increase – to \$230,000. If the first excess followed the 15% increase, the renewal premium would be \$115,000. In today's market, ILFs are also rising. At an ILF of 60%, the renewal premium of \$138,000 is \$23,000 more than if they just agreed to follow the 15% primary rate increase. Further, the second excess also quoted a 60% ILF. The compounding effect is a premium increase of 51% for the second excess. The end result: a 15% primary increase compounded to a 27% overall increase.

Expectations

It is not uncommon today to see excess carriers quoting ILFs anywhere from 65% – 100% (or more in extreme cases). We are also seeing carriers manage their capacity. It is not uncommon for a carrier who had \$15M or more at expiring to want to reduce their capacity to \$10M. Currently, there is not a problem replacing this capacity, but it will cost more than the expiring capacity.

Recommendations:

- Make sure your broker understands this market dynamic, keeps you apprised and differentiates your risk profile in the marketplace. Start the renewal process early but anticipate that the market will continue to rapidly change and evolve.
- Involve excess insurance carriers in underwriting meetings with senior executives. Consider allocating additional time with key excess players and not just the primary carrier.
- Be open to potentially new program structures and insurance carriers.
- Discuss with your broker the claim handling reputations of the current and proposed carriers. With the increased likelihood that excess carriers will be involved in the event of a loss, it is critical to have excess carriers who have experience in effectively handling complex claims.



Conclusion

The good news is that getting the desired excess capacity is not difficult for most companies (D&O limits for IPOs and companies with troubled risk profiles can be a challenge). Even buying higher limits is generally not a problem. The bad news is that it will likely cost considerably more premium for the same limits. Insurance carriers are no longer aggressively competing for excess layers, even when the incumbent is seeking a significant increase. So, while your primary D&O insurance relationship is extraordinarily important, it is only the first step in building your D&O program. The excess renewal negotiations may prove to be more challenging than your primary negotiations, and negotiating excess placements will also take longer than they have in the past. Making budget projections based on any guidance received from your primary carrier only without factoring in the compounding effect of the excess layers will likely be inaccurate. While there is still plenty of excess capacity in the market, carriers are displaying pricing discipline and it is simply costing more.

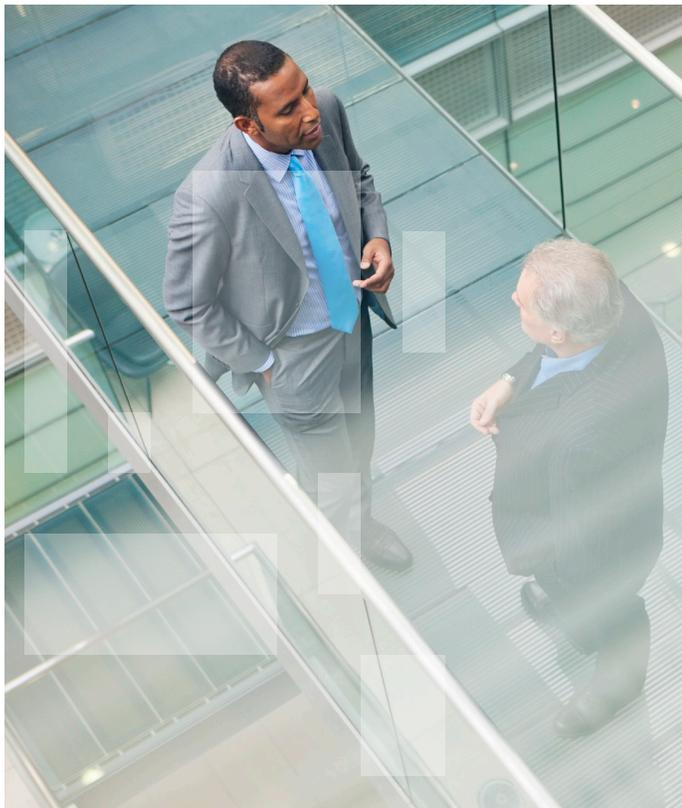
Insurance coverage for civil investigative demands

By Charles J. Madden, III

Background

Civil investigative demands (CIDs) are demands to produce documents, answer interrogatories and provide written reports. They may be issued by the Department of Justice, States' Attorneys General or federal and state agencies. A party receiving a CID may be the target of the investigation or a third-party witness. The CID may also advise whether the target is under investigation for possible violations of law. CIDs may relate to antitrust, consumer protection or false claims act allegations.

Upon receiving a CID, the target of the CID may negotiate to narrow its scope. When that does not work, the target of the CID may also challenge the CID in court. In any event, responding to and/or negotiating/challenging a CID can be costly.



Policy solutions for CIDs

More recently, language has been added to insurance policies to address the growing frequency of CIDs. Those solutions usually include adding the terms investigation or regulatory proceeding to the list of situations constituting a claim. The definitions of investigation and regulatory proceeding will include CIDs. There are some slight differences in how CIDs are handled within these definitions as demonstrated below.

Example A:

Investigation means an investigation of an insured by an enforcement unit, commenced when such insured is a target of the investigation for a wrongful act, and has received a:

- Subpoena
- Civil investigative demand
- Grand jury subpoena
- Search warrant
- "Target letter" (within the meaning of Title 9-11.151 of the United States Attorney's Manual)
- Wells Notice formal order of investigation
or
- The foreign equivalent to any of the foregoing from such enforcement unit, provided that the company shall take into reasonable consideration all extrinsic evidence presented by the insured to determine if and when such insured is a target of such investigation for a wrongful act

Example B:

Regulatory defense and penalties to pay on behalf of any insured:

Claims expenses and penalties in excess of the retention, which the insured shall become legally obligated to pay because of any claim in the form of a regulatory proceeding, first made against any insured during the policy period or optional extension period (if applicable) and reported in writing to the underwriters during the policy period or as otherwise provided in Clause IX. of this policy, resulting from a violation of a privacy law and caused by an incident described in Insuring Agreement C.1., C.2. or C.3 that first takes place on or after the retroactive date and before the end of the policy period.

Claim means: ...with respect to coverage provided under Insuring Agreement E only, institution of a regulatory proceeding against any insured.

Regulatory proceeding means a request for information, civil investigative demand, or civil proceeding commenced by service of a complaint or similar proceeding brought by or on behalf of the Federal Trade Commission, Federal Communications Commission, any authorized data protection authority, or any federal, state, local or foreign governmental entity in such entity's regulatory or official capacity in connection with such proceeding.

Example C:

Regulatory proceeding means a request for information, civil investigative demand or civil proceeding commenced by service of a complaint or similar proceeding that involves an electronic banking act, an electronic publishing act or a security breach taking place after the retroactive date, if any, and that is brought by or on behalf of the Federal Trade Commission, Federal Communications Commission, the Federal Deposit Insurance Corporation, the Comptroller of the Currency, the Consumer Financial Protection Bureau, the National Credit Union Administration, the Treasury Department or any federal, state, local or foreign governmental entity in such entity's regulatory or official capacity.

In Example A, broad coverage is provided for CIDs; however, coverage is limited to those situations where an insured is the target of the investigation. In Example B, coverage is limited to claims expenses and penalties. Finally, in Example C, coverage for CIDs is limited to specific acts.

When the policy is silent on CIDs

When the policy is silent on CIDs, coverage will likely be determined by what constitutes a claim under the applicable policy – and can lead to mixed results as to coverage. This uncertainty is apparent in a recent opinion issued by the Superior Court of Delaware on June 24, 2019.

At the outset, the Court noted the split of authority as to what constitutes a claim, where the policy is silent as to coverage for CIDs. The policy at issue defined claim, in part, to include “a written demand for money, services, non-monetary relief or injunctive relief...” The Court proceeded to compare the contrasting case law to determine whether a CID is a claim.

The Conduent Court pointed out several court opinions indicating that a CID was not a claim, as well as discussing several court opinions indicating that a CID was a claim.

The Conduent Court determined that the authority supporting the position that the CID constitutes a claim is more persuasive, noting that the CID requested information in connection with an investigation targeting the insured relating to unlawful acts possibly committed by the insured. As such, the Conduent Court ruled that the CID is a claim for non-monetary relief alleging a wrongful act.

In sum, where the policy does not specifically address coverage for CIDs, coverage will likely turn on a determination as to whether the CID is a claim for non-monetary relief. Some factors for such a determination include whether wrongful acts are alleged and whether the investigation focuses on the insured. Unfortunately, as demonstrated above, regardless of such factors, different courts have reached different results based upon similar facts. Such inconsistency is not helpful to insureds when faced with a CID.

In light of the above, we recommend including CIDs in the definition of claim for greater certainty. Willis Towers Watson works closely with insurers to address your insurance coverage concerns, including coverage for CIDs.

Conduent State Healthcare, LLC v. AIG Specialty Ins. Co., CVN18C12074MMJCCLD, 2019 WL 2612829 (Del. Super. Ct. June 24, 2019).

See MusclePharm Corp. v. Liberty Ins. Underwriters, Inc., 712 Fed. Appx. 745 (10th Cir. 2017), (SEC Order and subpoenas were not a claim due to the lack of any alleged wrongdoing.); Employers' Fire Ins. Co. v. ProMedica Health Sys., Inc., 2013 WL 1798978 (6th Cir.), (FTC letter and subpoenas were not a claim due to lack of alleged wrongful conduct.); W.R. Starkey Mortgage, LLP v. Chartis Specialty Ins. Co., 2013 WL 12138896 (E.D. Tex. June 27, 2013), (DOJ request for information not a claim.); First Horizon Nat'l Corp. v. Houston Cas. Co., 2017 WL 2954716 (W.D. Tenn.), (CID issued by DOJ not a claim due to lack of allegations of a Wrongful Act.).

See Syracuse Univ. v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA, 2013 WL 3357812 (N.Y. Sup. Ct.), (Grand jury investigation and subpoenas constituted written demand for non-monetary relief.); MBI Inc. v. Federal Ins. Co., 652 F.3d 152 (2d Cir. 2011), (Government investigative subpoenas constitute claim.); Weaver v. Axis Surplus Ins. Co., 2014 WL 5500667 (E.D.N.Y.), (Attorney general letter is a claim because it is a request for non-monetary relief.); Minuteman Int'l, Inc. v. Great Am. Ins. Co, 2004 WL 603482 (N.D. Ill.); (SEC order and subpoenas constitute claim as they were demands for something due.).

Broadening definitions of claim: Be careful what you wish for

By John D. Shugrue, Reed Smith LLP

As the song in the famous musical says, “No good deed goes unpunished.” In the D&O coverage arena, this statement aptly can be applied to characterize the sometimes unfortunate (and always unintended) negative consequences on coverage of the broadening of the definition of claim and inclusion of coverage for certain pre-claim matters in D&O policies. The expansion and enhancement of coverage for a broader range of claims sometimes has produced the opposite effect of limiting coverage, as insureds have not adequately addressed notice to D&O insurers of the expanded range of events that qualify as claims.

Historically, efforts to expand the definition of claim and include coverage for pre-claims has been a reasonable response to a legitimate issue. For years, D&O coverage disputes arose as to whether and when a claim as defined in, and covered by, D&O policies existed. Although things like lawsuits and criminal indictments were easily recognized as claims, gray areas emerged as to pre-lawsuit subpoenas, administrative investigations, or verbal demand for payment (or, even more gray, for injunctive or equitable relief). The need for D&O coverage for such matters was heightened by the increasing and more aggressive use by regulatory and administrative agencies of investigative tools that could be implemented even without initiating formal litigation or administrative actions.

In order to address these issues, D&O coverage was gradually broadened to encompass activities that would not qualify as claims under the traditionally narrow definition, but nevertheless typically resulted in the insured having to incur legal costs in responding to or addressing the situation. Examples of the expanded coverage include broadening the definition of claim to include verbal demands, investigative subpoenas, “informal” administrative or regulatory requests for interviews of witnesses, and production of documents. The salutary effect of this broader coverage was to afford greater protection under D&O policies for circumstances that clearly crossed the line into adversarial, or at least quasi-adversarial, proceedings but were not lawsuits, written demands for payment, criminal indictments or the like.

However, the unintended and unfortunate (as well as typically unforeseen) consequence of this expansion of coverage has been to expose insureds to potentially adverse consequences (i.e., loss of coverage) for failure to timely or properly provide notice of the new brand of claims per the expanded definition of claim. D&O policies often cover only claims that are “first made” during the policy period. They also typically treat all related or interrelated claims as having been “first made” when the earliest such claim was made.

The gray-area type claims may not receive the same attention as would the filing of a lawsuit or issuance of an administrative order. Insureds that are less experienced or sophisticated in D&O insurance may fail to appreciate the need to provide notice of matters falling within the broader universe of covered claims. The trap for the unwary insured is, therefore, the failure to timely report a gray-area claim (such as a subpoena or administrative request for documents, request for interview of an individual insured, or a verbal demand for payment) and, as a result, forfeiting coverage for a later filed (and related) lawsuit or criminal indictment. The failure to report a gray-area claim is not unusual; in many circumstances insureds may not believe that it qualifies as a claim or may assume that unless it ripens into a lawsuit, notice is not required. The expansion of coverage, which should be beneficial to an insured, can thus become grounds for denying coverage for a legitimate claim. D&O insurers appear ready and willing to exploit these situations by aggressively asserting the coverage defense that a claim was not first made and reported during the policy period if there was a gray-area claim made against the insured in a prior period, but not reported at that time.

There are, however, ways to address this situation and ameliorate the unintended negative consequences of broad claim definitions. One way is to expressly provide in the policy that a failure to report certain gray-area claims or pre-claims during a prior policy period will not prejudice coverage for a later-reported (and related) lawsuit or other traditional type claim. Another option is to modify the policy provisions concerning related or interrelated claims to except gray-area claims or pre-claims from such provisions for purposes of excluding coverage for later-made traditional claims.

The tradeoff would be that an insured that fails to timely report the gray-area claim or pre-claim cannot obtain coverage for the gray area claim or pre-claim, although it may still obtain coverage for the later-reported traditional claim.

As a more practical matter, insureds need to be better informed and more diligent about both the scope of their D&O coverage and timely reporting the full array of covered claims to their D&O insurers. Coordination and communication between and among the insured's legal and risk functions is of paramount importance in this regard. Likewise, insureds should take full advantage of the expertise and experience of their outside insurance advisors, including brokers and coverage counsel.

Good deeds in the form of obtaining broader D&O coverage should be rewarded, not punished. Insureds that take appropriate steps to safeguard and maximize the value of their coverage will be duly rewarded for their efforts.



A roadmap to navigating the hardening D&O marketplace

By John M. Orr

Introduction

Having crossed into the second half of 2019, and with the release of mid-year securities litigation reports behind us, a consistent theme permeates the directors & officers liability insurance marketplace: securities litigation filings have held steady at near record levels for more than two years, median and average settlements have increased, and D&O insurance premiums are on the rise. The last time we experienced similar market conditions was in the early 2000s, before many of today's risk professionals were in positions to oversee organizational insurance programs.

Below is a primer, a roadmap, for risk professionals who have not experienced a hardening market. The purpose is to assist them in making sense of tightening conditions and to guide them in taking steps to mitigate against the market's impact on their organizations.

What is a “hard” (or “hardening”) insurance market?

In general, a market can be characterized as “hard” when there is an increased demand for coverage, coupled with a reduced supply. Competition for business has diminished. Policy premiums are higher year-over-year, often significantly higher, for the same levels of (or often less) coverage, and even for those companies with little or no material change in risk profile.

In a hard market, insurers might not only increase premiums, they may also force policyholders to retain more risk in the form of higher self-insured retentions and deductibles. They will apply stricter underwriting standards, narrow existing coverages, and potentially walk away from new business and renewals if the insured is unwilling to agree to their terms. To be fair, in almost all instances, underwriters are adhering to their managements' more aggressive premium and revenue mandates, as well as efforts to reduce claim exposures and losses. The impact to insureds is nevertheless the same: companies may be paying more and getting less.



To characterize a market as “hardening” (also “tightening” or “firming”) is to suggest that the market has begun to develop tightened conditions but is not yet in a truly “hard” state. This describes our current marketplace. Today, for instance, premiums and retentions have trended upwards, but some levels of insurer competition remain, thus staving off more severe increases. Also, we have not yet experienced a trend in insurers pulling back on terms and conditions, as some companies with favorable risk profiles continue to enjoy broad coverage and, in some cases, enhanced terms at renewal.

What is causing a hardening market?

The form of claim activity that most impacts public company D&O insurers is the securities class action (SCA) filed in federal court. Because of federal law requirements associated with public notices of class actions, it is relatively easy to track and study SCAs. Among other things, we know how many of them are filed and where they are filed. We know when and to what extent they are dismissed, and we know when and at what levels they are resolved.

Armed with these capabilities, we are aware that the average number of SCAs filed each year from 1996 to 2016 was 219.¹ In 2017, the landscape changed. A staggering 412 SCAs were filed that year.² In 2018, 402 were filed.³ In the first half of 2019, 198 were filed (prorated to a full year frequency of 396).⁴ Stuningly, more SCAs were filed in the first half of 2019 than in the full year of 11 of the previous 23 years!⁵

Why are more SCAs being filed? Consider the following (in no order of significance):

- **IPOs** – More companies than in recent years are filing for initial public offerings (IPOs) and, in many of those instances, the quality of the offerings are questionable. For example, many IPO companies remain unprofitable.⁶ Also, smaller offerings permitted under federal law⁷ may allow for an expedited process with fewer disclosures and, thus, less transparency. This has the potential to make companies and their directors and officers more susceptible to allegations of fraud.
- **M&A Objection Litigation** – Federal court SCAs arising from M&A activity, brought by shareholders alleging an unfair valuation of their shares in a transaction, began to increase in frequency in 2016, exploding in 2017 and 2018. The phenomenon began when the highly influential Delaware Chancery Court declined to approve what was a customary form of settlement in which certain proxy disclosures were tweaked, plaintiffs’ attorneys were compensated, but shareholders received little or no material benefit. With the court articulating it would reject similar settlements in the future, the proverbial spigot was turned off in state court, leading plaintiffs’ attorneys to seek a more hospitable environment in federal court. Arguably, the migration did not result in an increase of claims that insurers were handling; however, merger objection cases have since become costlier to litigate and resolve.⁸
- **Event-driven SCAs** – Unlike traditional SCAs, in “event-driven” litigation, a company’s stock decline was not caused by corrective disclosures relating to financial matters, such as financial restatements. Rather, it was caused by an adverse event, such as a product recall, wildfire, accident, etc. For plaintiffs, tragedy beget opportunity. In particular, they allege that the event rendered previous, more assuring, public disclosures misleading, resulting in purported violations of the federal securities laws. As matters involving financial irregularities have diminished, the plaintiffs’ focus on events as a source of additional SCA activity has been a notable trend.⁹
- **Emerging plaintiffs’ firms** – Historically, the number of law firms filing securities litigation was relatively small. In contrast, newer entrants in the plaintiffs’ bar are filing more cases. Commentators, including academics, have referred to the firms as “emerging” (as opposed to “established” firms) and have considered many of their pleadings to be of lesser quality.¹⁰ Regardless, the phenomenon has necessarily resulted in increased costs and expenses.



Other factors leading to the hardening marketplace include:

- **Cyan: Litigation in multiple venues** – In March 2018, the United States Supreme Court issued a ruling in the case of *Cyan, Inc. v. Beaver County Employees Retirement Fund*.¹¹ At its core, Cyan allows for litigation involving IPOs and secondary offerings to be asserted in federal court and simultaneously in state court. The court’s decision was based on a strict reading of governing law, something that, in a different political climate, might be relatively easy to address with corrective legislation. In the interim, however, litigation in multiple venues is resulting in increased costs and expenses, as well as the potential for more significant liability considering different state law standards and less sophisticated judiciaries.
- **Fewer public companies/smaller risk pool** – Despite an increase in IPOs, there are fewer publicly traded companies now than in years past. At the end of 1996, there were 8,090 public companies in the U.S. At the end of 2018, there were 4,397 – a decrease of 46%.¹² As a result, insurers are underwriting fewer public companies, yet they are having to address a greater number of SCAs. Stated differently, insurers are less able to spread the litigation risk across a broader risk pool.
- **Average settlement values have more than doubled** – The average SCA settlement is on the rise. In 2018, it was \$69 million, a 176% increase over 2017’s average of \$25 million, and on par with the 2016 average of \$73 million.¹³ These extreme differences can be explained, in large part, by a greater number of “mega” settlements in 2016 and 2018 (settlements in excess of \$100 million), which have the effect of skewing averages.
- **Median settlement values have more than doubled** – Even disregarding average settlement figures, the median SCA settlement also more than doubled in a one-year period, from \$6 million in 2017 to \$13 million in 2018.¹⁴

How can companies mitigate the impact of the hardening market?

With a hardening market settling in, below are measures that risk professionals and their organizations can implement to mitigate against oncoming adverse conditions.

- **Start early** – Engage with your broker early in the renewal process. Develop renewal pricing expectations, but be prepared for those expectations to change. In this regard, an underwriter’s initial pricing estimates may become noticeably different during the renewal process. Broker communications on changing conditions are critical. Likewise, internal budgeting should be reevaluated and adjusted as warranted.
- **Stand out among peers** – In renewal discussions with underwriters, your broker should highlight factors about your risk profile that differentiate you in this challenging market. For example:
 - Where applicable, you may not be the kind of acquisitive company that most exposes you to merger objection SCAs.
 - Where applicable, you may have no intention of filing for an IPO or secondary offering that exposes you to Cyan risks. Even if you are preparing for an IPO, you may not fit the profile of the riskier types of companies engaging in the process.
 - Where applicable, you may not be in an industry that is most impacted by securities litigation risk. The three most frequently sued industries in 2018 were (1) health technology and services, (2) electronic technology and technology services and (3) finance.
- **Model your risk** – Whether or not your risk is increased for one reason or another, be sure that your broker is employing data to mitigate market impact. Is your broker modeling your organization’s risk to highlight financial metrics and other factors that serve to emphasize a diminished susceptibility to risk and potential loss severity?

- **Beef up coverage breadth** – Seek coverage/policy wording improvements to lessen the risk of unnecessary coverage limitations in the event you are the subject of a claim. Your broker should be staffed with seasoned coverage and claims professionals who audit policies and negotiate best-in-class language for you. Remember that, although the market is hardening, we are not yet experiencing a constriction in coverage breadth.
- **Evaluate corporate governance and cybersecurity practices** – Periodically engage providers to take a fresh look at your organization’s corporate governance practices, in addition to its cybersecurity infrastructure. There is no shortage of authority linking cybersecurity to D&O risk.¹⁵
- **Consider alternative program structures** – Evaluate different program structures, such as lowered limits, increased retentions, reduced ABC coverage in favor of greater Side A DIC coverage, and other structural options that can have the effect of reducing premium. In doing so, however, exercise significant caution! It is likely you played an important role in designing your company’s current program based on sound analysis and broker guidance. Especially in today’s marketplace, increasing your organization’s risk may be penny wise and pound foolish.



Conclusion

For many of today’s organizational risk professionals, a hardening D&O marketplace is uncharted territory. Take time to educate yourself and consider what a firming market means for your organization. Above all, work closely with your broker and other professionals to address and offset anticipated issues/concerns and to set yourself up for a successful renewal.

¹ Stanford Law School, Cornerstone Research, Securities Class Action Clearinghouse, <http://securities.stanford.edu/charts.html>, accessed August 16, 2019.

² Id.

³ Id., see also Cornerstone Research, “Securities Class Action Filings: 2018 Year in Review.”

⁴ Cornerstone Research, “Securities Class Action Filings: 2019 Midyear Assessment,” p. 1.

⁵ Id., see also, Stanford Law School, Cornerstone Research, Securities Class Action Clearinghouse, <http://securities.stanford.edu/charts.html>, accessed August 16, 2019.

⁶ See, e.g., Wilhelm, Alex, “Unprofitable IPOs Are Getting Bigger,” Crunchbase News, <https://news.crunchbase.com/news/unprofitable-ipos-are-getting-bigger>, June 5, 2019.

⁷ Jumpstart Our Business Startups Act, or “JOBS Act,” Pub.L. 112-106.

⁸ See, e.g., LaCroix, Kevin, “The Growing Costs of Merger Objection Litigation,” The D&O Diary, <https://www.dandodiary.com/2018/07/articles/merger-litigation/growing-costs-merger-objection-litigation>, July 11, 2018.

⁹ See, LaCroix, Kevin, “Scrutinizing Event-Driven Securities Litigation,” The D&O Diary, <https://www.dandodiary.com/2018/03/articles/securities-litigation/scrutinizing-event-driven-securities-litigation>, March 27, 2018, discussing Coffee, Jr., John C., “Securities Litigation in 2017: It Was the Best of Times, It Was the Worst of Times,” The CLS Blue Sky Blog: Columbia Law School’s Blog on Corporations and the Capital Markets, <http://clsbluesky.law.columbia.edu/2018/03/19/securities-litigation-in-2017-it-was-the-best-of-times-it-was-the-worst-of-times>, March 19, 2019.

¹⁰ For a discussion of “emerging” firms, see Klausner, Michael and Hegland, Jason, “Guest Post: Deeper Trends in Securities Class Actions 2006-2015,” The D&O Diary, <https://www.dandodiary.com/2016/06/articles/securities-litigation/guest-post-deeper-trends-in-securities-class-actions-2006-2015>, June 23, 2016, and cited by LaCroix as a factor in increased 2017 and 2018 SCA filings. See, LaCroix, Kevin, “The Top Ten D&O Stories of 2018,” The D&O Diary, <https://www.dandodiary.com/2019/01/articles/director-and-officer-liability/top-ten-stories-2018>, January 7, 2019.

¹¹ 583 U.S. ___, 138 S. Ct. 1061; 200 L. Ed. 2d 332 (2018).

¹² The World Bank, <https://data.worldbank.org/indicator/CM.MKT.LDOM.NO?locations=US>, accessed August 16, 2019.

¹³ NERA, “Recent Trends in Securities Class Action Litigation: 2018 Full-Year Review,” https://www.nera.com/content/dam/nera/publications/2019/PUB_Year_End_Trends_012819_Final.pdf, p. 28.

NERA, “Recent Trends in Securities Class Action Litigation: 2018 Full-Year Review,”

¹⁴ NERA, “Recent Trends in Securities Class Action Litigation: 2018 Full-Year Review,” https://www.nera.com/content/dam/nera/publications/2019/PUB_Year_End_Trends_012819_Final.pdf, p. 30.

¹⁵ See, e.g., Meer, Jonathan E., “Directors and Officers: Be Wary of Growing Cyber Responsibilities,” Wilson Elser Moskowitz Edelman & Dicker LLP, https://www.wilsonelser.com/news_and_insights/attorney_articles/3274-directors_and_officers_be_wary_of_growing_cyber?utm_source=Mondaq&utm_medium=syndication&utm_campaign=View-Original, December 2018.

SEC enforcement is not just a public company concern: What private companies need to know

By Nicholas Bolton

Private companies are subject to SEC oversight too, and this has implications for your D&O policy. Regardless of a company's status as publicly traded or privately held, the SEC has authority to investigate all companies that seek to raise capital from U.S. investors.

It is a common misconception that publicly traded companies are the sole target of regulatory enforcement as it pertains to securities. In order to understand why that misconception has manifested, it is helpful to start by considering the plethora of securities litigation aimed at public companies. Those who operate within the public company D&O liability sphere will be acutely aware of the record number of securities class actions that have been filed since 2017. This has been driven, in large part, by the escalating number of merger objection litigation claims, event-driven claims (think non-traditional root causes, such as cyber breaches, adverse weather events, etc., as opposed to the traditional accounting misrepresentation trigger) and the augmented rate year over year at which private companies are undertaking initial public offerings. Increasingly, the plaintiffs' bar is employing an inventive array of mechanisms to bring suit against both publicly traded and private companies alleging violations of securities laws, and it appears that there is little that will dampen their enthusiasm to proceed in this fashion for the foreseeable future.

Whether these securities class actions are brought with or without merit, the protections afforded to investors in public companies by the federal securities laws (namely the Securities Act of 1933 and the Securities Exchange Act of 1934) are both well-documented and designed to ensure an established framework of compliance for publicly traded companies. These laws intend to ensure adequate safeguards and disclosures for those individuals who wish to invest in these companies. Indeed, the Securities and Exchange Commission (SEC) Division of Enforcement is the established watchdog in this arena, with the authority to investigate possible violations of the federal securities laws committed by publicly traded companies and their executives.

But what about private companies? Much less has been written about the extent to which the SEC has authority in the privately held space. Those who place executive lines of insurance coverage will, of course, be familiar with the SEC's oversight of financial institutions (two key regulations being the Investment Advisers Act of 1940 and the Investment Company Act of 1940), but there is less familiarity with how non-financial institution private companies fall within the SEC's purview.

As previously alluded to, the common assumption is that the dividing line for SEC oversight is the public versus private company distinction. The distinction gives rise to differences in D&O coverage for public versus private companies, including coverage for securities claims granted in a public company D&O policy wording and, conversely, the securities offering exclusion found within private company D&O policy wordings. It is a timely reminder, then, that all companies seeking to raise capital from U.S. investors are subject to the SEC's anti-fraud provisions.

The anti-fraud provisions are set forth in Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. Section 10(b) provides as follows:

"It shall be unlawful for any person, directly or indirectly... to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered...any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."¹

Clearly, the SEC's authority under 10(b) extends even to those securities not registered on a national securities exchange. Even those transactions that meet certain exemption criteria are subject to the SEC's oversight, which means responsibility lies with all companies for all false or misleading statements they may make as part of the offering process. As if being subject to the SEC's authority isn't enough, companies are also subject to individual state laws ('blue sky laws') which are enforced by the individual state's own securities regulator,

¹ Section 10(b) of the Securities Exchange Act of 1934 is codified at 15 U.S.C. § 78j

who also has the authority to bring enforcement actions for fraud against companies undertaking offerings, even if those offerings also meet any exemptions outlined under the Securities Act. The underlying message, then, is that all companies undertaking offerings in the U.S. are subject to the SEC's anti-fraud provisions, regardless of whether they are public or private, and regardless of whether the offerings they are undertaking meet exemption thresholds outlined in the Securities Act.

While the rate at which private companies are undertaking IPOs has recently increased, the number of publicly traded companies is certainly a lot lower than it used to be. For example, at the end of 1996, there were 8,090 public companies in the U.S. At the end of 2018, there were 4,397.² In turn, the number of 'Unicorn' companies, i.e., those privately held entities with valuations exceeding \$1B, has proliferated in recent years. Several of these companies have conducted IPOs in recent months, but the journey to becoming publicly traded hasn't always been smooth. As more information is filed publicly with the SEC as part of the IPO process than would otherwise have previously been available, frequent concerns among investors include (1) the underlying substance upon which the superlative valuations are predicated (which becomes increasingly subject to challenge when previously undisclosed financial data is made available), and (2) that such companies have not grown adequately from an operational, regulatory and compliance perspective in line with their valuation.

This was a core focus of the SEC's Silicon Valley Initiative in 2016. In this regard, Mary Jo White (then chair of the SEC) had made clear that "the risk of distortion and inaccuracy is amplified because start-up companies, even quite mature ones, often have far less robust internal controls and governance procedures than most public companies." As a result, we can only expect that the SEC's focus on private companies will intensify, particularly as many companies' valuations (most notably in the tech sector) quickly outgrow their internal controls.

² The World Bank, <https://data.worldbank.org/indicator/CM.MKT.LDOM.NO?locations=US>
³ Mary Jo White, Keynote Address at the SEC-Rock Center on Corporate Governance Silicon Valley Initiative (March 31, 2016)

So, what are some of the steps that private companies should take to ensure that their D&O coverage is sufficiently broad? First, seek to minimize the extent to which the Publicly Traded Securities exclusion (found in private company D&O forms) will apply, by ensuring that the exclusion at a minimum includes carve-backs for the following:

- Ensure that the purchase or sale of securities are exempt from the requirement to be registered under the Securities Act of 1933 (or foreign equivalent).
- Ensure that the exclusion is limited to public offerings of equity securities of the organization, versus debt securities. Public offerings of debt securities should not be subject to the policy exclusion.
- Make sure that all pre-IPO activity (roadshows etc.) is not excluded, and that coverage is also included for any failed initial public offering, to the extent that the IPO does not take place.

Finally, it is vital to ensure that the policy includes broad investigation coverage for all directors and officers. Regulatory inquiries can be protracted and costly and often will not meet the definition of claim as it is set out within the base D&O policy. Building this coverage into the policy will assist in protecting the C-Suite as they navigate the increasingly challenging private company regulatory environment.



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