IMA Executive Risk Solutions

Quarterly Update – 3Q2018

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Cases of Interest

Spinoff of Subsidiary Deemed a Securities Claim for which Insurers Wrongfully Denied Coverage under Directors & Officers Liability Policy

Over a decade after the transaction in question was completed, a Delaware court found in favor of insureds seeking coverage under a directors and officers liability (D&O) insurance program for defense costs incurred after the transaction was challenged in court.

In 2006, Verizon Communications transferred its print and electronic directories business into a standalone company in exchange for stock in that company and promissory notes. The stock was distributed to Verizon shareholders and the notes were exchanged for debt securities, which were then sold on the open market. The newly independent company did not last long and filed for bankruptcy protection within a few years. A litigation trustee was then appointed as part of the bankruptcy case to recoup shareholder funds, which resulted in claims being asserted against Verizon and certain executives of the company.

Verizon eventually prevailed and sought coverage from its D&O insurers for the $48.5 million spent in defense costs. All of the D&O insurers (primary and excess) denied coverage, and this litigation ensued.

The question of coverage turned on whether the claims asserted constituted 'Securities Claims' as defined in the policies. Rejecting the insurers' narrow interpretation of the definition, the court held the insurers liable for the insured's defense costs.

The court further found the insurers' refusal to advance defense costs in derogation of their obligations based on language in the primary policy specifying that fair and proper defense costs must be paid even in the absence of an agreement about the final amount.

The court similarly rejected the excess insurers' arguments regarding exhaustion of the underlying layers as a defense to payment. "The Defendants' position lived and died on the issue of 'Securities Claim', and to continue the litigation would not only be unreasonable but would condone the excess insurers continual failure to comply with the insurance policies." *Verizon Communications Inc., et. al., v. Illinois National Insurance Company, et. al.*, 2018 WL 2317821, Del. Super. May 16, 2018.

Cases of Interest

Exhaustion of D&O Policy Limit Upheld, Even When Policy is an Asset of a Bankruptcy Estate

Following the initiation of an enforcement proceeding by the Securities and Exchange Commission (SEC) against former executives of a company in bankruptcy, advancement under the company's directors and officers liability (D&O) policy was sought to fund the executives' defense.

The bankruptcy court here appointed a temporary receiver and froze the assets of the receivership estate. The SEC then requested the asset freeze be expanded to encompass *all* assets of the company, including the D&O policy proceeds.

While noting the policy proceeds are within the receivership estate assets, the Texas court found this did not preclude allowing advancement of defense costs to insured persons under the policy.

Eventually, the policy proceeds were exhausted and the Receiver sought a court order requiring the executives to provide security for reimbursement of amounts advanced if the claims against them could not be collected at the conclusion of the enforcement proceeding.

In rejecting the Receiver's request, the court held the insureds demonstrated a current right to payment under the policy which is superior to any potential rights of the Receiver. The court relied on the priority of payments provision in the policy along with the fact that the Receiver possessed no ability to negate the contractual rights of insureds under the policy.

The court further rejected the Receiver's request for the insureds to provide security for repayment in the event reimbursement is later required, explaining that no such requirement existed in the policy or in law. As such, the former executives' defense costs were funded up and through exhaustion of the policy limit. *Securities and Exchange Commission v. Faulkner*, 2018 WL 3708426 (N.D. Tex. August 3, 2018).

Insurer's Reliance on Breach of Contract Exclusion Rejected and Defense Owed to Insured

The Fifth Circuit Court of Appeals held a private company management liability policy affords coverage for at least defense costs in a case alleging claims for breach of contract and negligent conduct.

Noting that "[w]here an underlying petition includes allegations that go beyond conduct covered by an exclusion (i.e., breach of contract), the duty to defend is still triggered. Even in case of doubt as to whether or not the allegations of a complaint against the insured state a cause of action within coverage of a liability policy sufficient to compel the insurer to defend the action, such doubt will be resolved in the insured's favor."

Finding the pleadings and demand letters to include references to non-compliance with third-party security standards separate and apart from the contracts in place between the underlying litigants, the appellate court reversed the trial court's judgment in favor of the insurer.

Cases of Interest

Insurer's Reliance on Breach of Contract Exclusion Rejected and Defense Owed to Insured *(continued)*

"Simply put, the district court's assertion that [the insured] failed to allege any facts that show it would be liable or have any form of privity or obligation to pay damages to [the third party] for any other reason than those that arise out of contractual liability rewrites the allegations, ignoring statements in the demand letters that do not depend upon the Merchant Agreement, such as [the insured's] negligence in not complying with the Payment Card Industry Data Security requirements and demands for a type of non-monetary relief not contemplated by the Merchant Agreement." As such, the insurer was found to have breached its obligations under the duty to defend policy and the trial court's decision was reversed on appeal. *Spec's Family Partners, Ltd. V. The Hanover Insurance Company*, 2018 WL 3120794, (5th Cir. June 25, 2018).

U.S. Supreme Court Holds Administrative Law Judges Subject to Appointments Clause

This past summer, after a protracted debate and numerous courts struggling with the question of whether Administrative Law Judges (ALJs) were subject to the Appointments clause in the U.S. Constitution, the U.S. Supreme Court held they are.

Prior to this decision, ALJs had been selected and appointed by staff members of the SEC. At the conclusion of an SEC enforcement proceeding or hearing, the ALJ issues a decision that can be reviewed or adopted by the SEC. If the Commission opts against review, the initial decision becomes final and deemed the action of the Commission.

In this case, the SEC had initiated an administrative proceeding against Raymond J. Lucia and his investment company for misleading statements intended to deceive prospective clients. The ALJ concluded that Lucia had violated the Investment Advisers Act and imposed civil penalties along with a lifetime ban from working in the investment industry.

Lucia challenged the ruling, arguing the proceeding itself was invalid because the ALJ had not been constitutionally appointed. The SEC rejected his appeal, as did the D.C. Circuit Court of Appeals. A panel of that court held SEC ALJs to be employees rather than officers, meaning they were not subject to the Appointments clause in the U.S. Constitution.

The D.C. Circuit's decision, however, conflicted with another case out of the 10th Circuit Court of Appeals that held ALJs were subject to the Appointments clause. The U.S. Supreme Court subsequently agreed to hear the case and sided with the 10th Circuit, finding the authority of ALJs similar to federal district court judges, who exercise wide discretion in conducting trials.

As a result of this decision, the SEC will likely be forced to conduct new hearings before properly appointed ALJs. Whether the SEC has the staff and wherewithal to do this, however, remains an open question. *Lucia, et. al. v. Securities and Exchange Commission*, 585 U.S. ___ (2018)

Cases of Interest

Securities Complaint Against ExxonMobil Over Global Energy Demand, Climate Change Policy and Carbon Asset Risks Survives Motion to Dismiss

As the debate about climate change and what to do about it, if anything, rages on, ExxonMobil is being sued for allegedly misleading statements in two reports issued in March of 2014.

The first report was titled "Energy and Carbon – Managing the Risks" and the second simply "Energy and Climate". The reports focused on possible governmental policy changes and the effects on oil and gas exploration, as well as concerns regarding global energy demand and supply, climate change policy and the risks associated with carbon as an asset.

After oil prices began to decline in mid-2014, other oil and gas companies were forced to write off or abandon more than $200 billion in oil and gas reserves because the production costs would exceed profits. ExxonMobil did not write off any assets and reassured investors that its superior investment processes and project management rendered an impairment unwarranted, and it subsequently completed a $12 billion public debt offering in March of 2016.

Approximately one month after the offering, ExxonMobil's credit rating was downgraded from AAA to AA+, and a few months later the company disclosed that nearly twenty percent of its proved oil and gas reserves no longer satisfied the SEC's 'proved reserves' definition.

In January of 2017, ExxonMobil announced it was recording an impairment charge of $2 billion, largely related to dry gas operations. Investors subsequently brought suit, alleging ExxonMobil's failure to write down or abandon assets was misleading because the company knew it could not survive the historic drop in oil prices without writing down assets. Claimants further alleged ExxonMobil refused to write down assets in advance of its March 2016 debt offering in order to maintain its AAA credit rating.

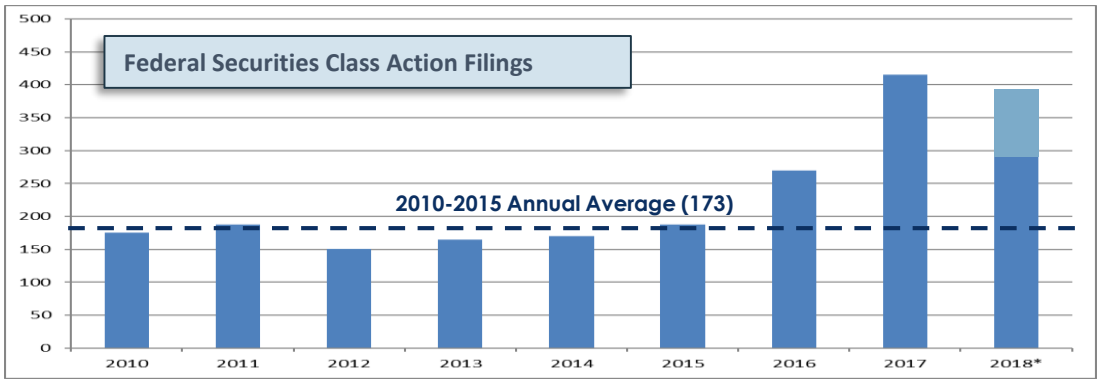
After carefully reviewing each alleged misrepresentation alleged by claimants, the court found in favor of the complaining shareholders, noting that information set forth in ExxonMobil's public filings was known by all but one corporate defendant, and that the complaint sufficiently alleged defendants were aware the financials included were misleading.

This is most likely not the last time a company's conduct with respect to climate change will serve as the basis of a securities lawsuit. As a result, any companies engaged in the exploration and production of hydrocarbons must be aware that any public statements, financials or issued reports will be heavily scrutinized for accuracy. *Ramirez, Jr. v. Exxon Mobil Corp., et. al.,* 2018 WL 3862083 (N.D. Tex. August 14, 2018).

D&O Filings and Other Developments

D&O Filings

- As we previously reported, 2017 D&O filings were up 54% over 2016 and at their second-highest level ever (highest = 2001)
- In 1H2018, filings continued at an elevated level, with 204 D&O Class Action Federal Securities Claims having been filed
- The elevated filing pace has continued through the first three quarters of 2018, with 292 claims having been filed
- Filing rates through September imply an annualized number of 390 D&O Class Action Federal Securities Claims
    - An annual total of 390 filings would exceed the 2010-2015 annual average of 173 filings by 125%
    - At this rate, **approximately 1 in 10 public companies are being sued for securities fraud**



**Projected 2018 filing total based on number of suits filed through September*

Other Developments and Considerations

- With D&O litigation remaining elevated, carriers are beginning to push for small rate increases on primary and low excess layers.
    - Primary and low excess layer price increases have been most noticeable for small cap companies.
    - Excess layer pricing remains noticeably more competitive than primary layer pricing, particularly in certain sectors.
- Despite the recent pricing adjustments on primary and low excess layers, overall pricing remains near a 15-year low.
    - Furthermore, already broad policy coverage terms continue to expand.
- A development we are watching closely is the rise in third-party litigation financing, and its impact on D&O litigation.
    - From 2013 to 2017, litigation financing has increased approximately 400%, and in the first week of October 2018, London-based litigation financier Burford Capital Ltd. alone raised $250 million to support ongoing efforts in the space.
- Another trend we are watching closely, and one that is possibly related to the prior note on litigation financing, is the continued increase in the number of D&O claims being brought by "emerging" law firms (i.e., those newer to the securities litigation space).
    - As a result, dismissal rates (which are already near an all-time high) are elevated for claims brought by these firms.
    - As these firms mature, it will be interesting to see if dismissal rates revert (i.e., drop) back to the historical mean.

Sources: Cornerstone Research; Stanford Law School

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IMA Financial Group is a privately held, diversified financial services firm focused on protecting client assets and creating exceptional value for our clients around the world. Our diverse team of experienced and talented professionals shares an unwavering commitment to excellence.

IMA Executive Risk Solutions is our world-class team of 20+ professionals focused on providing thoughtful advice, a unique legal perspective, a broad range of executive risk insurance solutions, and excellent service to our valued clients. Our professionals have deep experience handling complex executive risk exposures for a variety of clients – from pre-IPO start-ups to multi-billion dollar corporations.