IMA Executive Risk Solutions

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Cases of Interest

U.S. Supreme Court Upholds Liability of Individual Who Disseminated Misleading Information Supplied by Another

On March 27, 2019, the U.S. Supreme Court clarified whether a participant in a fraudulent scheme can be liable absent being the 'maker' of an untrue statement under Securities and Exchange Commission Rule 10b-5.

Rule 10b-5 makes it unlawful to: "(a) employ any device, scheme, or artifice to defraud; (b) make any untrue statement of a material fact; or (c) engage in any act, practice, or course of business that operates…as a fraud or deceit" in connection with the purchase or sale of securities.

The defendant, Francis Lorenzo, while acting as the director of an investment bank at a SEC registered brokerage firm, sent two emails to prospective investors that were supplied by his superior and described a potential investment. The emails included information Lorenzo knew to be untrue, namely that the company for which they were seeking investors had $10 million in assets, when in fact the assets were worth less than $400,000.

The SEC instituted proceedings against Lorenzo for violation of Rule 10b-5, Section 10(b) of the Securities Exchange Act of 1934 And Section 17(a)(1) of the Securities Act of 1933. After trial before an SEC Administrative Law Judge (ALJ), the ALJ found Lorenzo's actions to have violated all of the above, fined him $15,000 and barred him from working in the securities industry for life.

On appeal, the District of Columbia upheld the SEC's findings, but questioned whether Lorenzo could be liable under Rule 10b-5(b) since the email in question was supplied by his superior at the firm. The U.S. Supreme Court then agreed to hear the case to clarify the parameters of Rule 10b-5.

Basing its decision primarily on the fact that both the SEC and the D.C. Court of Appeals upheld the finding that Lorenzo knowingly disseminated false information to prospective investors, the Supreme Court had little trouble concluding his conduct ran afoul of subsections (a) and (c) of Rule 10b-5, even if Lorenzo wasn't the 'maker' of the statement (which means he could not be held liable under subsection (b) of the Rule). The Court rejected Lorenzo's argument that each subsection of the Rule governed different, mutually exclusive, spheres of conduct.

Cases of Interest

U.S. Supreme Court Upholds Liability of Individual Who Disseminated Misleading Information Supplied by Another *(continued)*

"[T]his Court and the Commission have long recognized considerable overlap among the subsections of the Rule and related provisions of the securities laws…Each succeeding prohibition was thus meant to cover additional kinds of illegalities, not to narrow the reach of the prior sections." The Court went on to note its decision was buttressed by the fact that the behavior here was plainly fraudulent, but under a different reading, would allow the perpetrator to escape liability.

The takeaway here is that even if an actor passes along information from someone else, but knew the information to be inaccurate, the actor can still be liable under federal securities laws. *Lorenzo v. SEC*, 2019 WL 1369839 (2018).

Rare Trial in Securities Class Action Ends with Both Sides Claiming Victory

Despite over 5,200 securities class action lawsuits having been filed since 1996, only twenty-five have ever been tried to verdict (with 13 going in favor of the plaintiff and 12 in favor of the defendant). However, on February 4, 2019, a jury in the Central District of California found in favor of plaintiff shareholders on one of four allegedly misleading statements that formed the basis of this case.

The defendant company, Puma Biotechnology, is a development stage biopharmaceutical company. Shareholders brought this case in 2015, alleging Puma failed to disclose material adverse facts about its lead drug candidate. An Order denying defendants Motion to Dismiss was entered in late September 2016 and the case went to trial in January of 2019.

Following trial, the jury found in favor of plaintiffs on one of the four allegedly false and misleading statements, and it specified damages of $4.50 per share of Puma stock. While post-trial proceedings remain ongoing, the damages claimants are entitled to as a result of the verdict remains unclear. A press release from the plaintiff's attorney specifies an award of up to $100,000,000. However, in the press release issued by Puma, the verdict is heralded as a success and in their view represents approximately five percent or less of the damages originally sought.

While an appeal remains possible, the 'final adjudication' language contained in the 'fraud' exclusion within Puma's directors and officers (D&O) liability policies must be considered. For this reason alone, a settlement appears likely; if the verdict is upheld after exhausting all available appeals, D&O insurers could seek to trigger the exclusion and deny coverage for the damages awarded. It is also possible the insurers could seek to recoup all defense costs expended, leaving defendants responsible for both their legal fees as well as the damages awarded.

This case serves as a reminder of the importance of a well constructed D&O program, without which the cost of litigating this matter (defense costs plus potential damages) might have been unthinkable. *Hsu v. Puma Biotechnology, Inc., et. al.*, Case No. SACV15-0865 (C.D. Cal. 2018)

Cases of Interest

Insured Forced to Reimburse Insurer for Defense Costs and Settlement

The insured in this case, a doctor, was sued for a variety of reasons and sought coverage under both a professional liability (E&O) and a commercial general liability (CGL) policy. The claims asserted in the underlying case alleged medical malpractice, albeit in a very roundabout way.

As the medical director of Aminokit Laboratories, Jonathan Lee, M.D. was the only employee of Aminokit with medical training. Upon learning this, patients treated at the clinic brought suit for misrepresentations, failure to provide adequate medical treatment and submission of fraudulent insurance claims.

The insured submitted the claim to its E&O carrier, which, following an initial denial, agreed to provide a defense under a reservation of rights. However, while the case was ongoing, the insurer filed a declaratory judgment action in Colorado District Court to have its coverage obligations adjudicated.

Before the Colorado case could be adjudicated, a settlement agreement was reached in the underlying claim against Aminokit and its employees (including the one doctor). The E&O insurer then sought contribution from the insureds for what it believed to be uncovered matters. The insureds refused, demanded that the insurer fully fund the settlement, and also threatened bad faith litigation against the insurer. The insured doctor further demanded that no portion of the settlement be allocated to him, so as to avoid having to report it to any medical board.

The insurer ultimately agreed to fund the entire settlement amount subject to its right to later seek reimbursement, and the settlement agreement was signed by all parties except the insured doctor, who refused to sign the agreement based on his prior objections. As a result, the insurer sought reimbursement of all defense costs expended on the insureds behalf along with the settlement payment under the theory of unjust enrichment. Based on the insured having obtained a benefit, namely the payment of a settlement and dismissal of the underlying case, the insured was found liable to the insurer for all funds expended on his behalf.

This case is an example of what can happen when an insured and its insurer fail to work cooperatively in the resolution of a claim. Here, an insured who refused to execute a settlement agreement that was funded by its insurer was ultimately forced to reimburse all previously covered amounts. It is imperative that insureds and their insurer communicate and work together to find mutually agreeable solutions, and a competent insurance broker with experienced claims professionals should be able to help facilitate such an outcome. *Evanston Insurance Co. v. Aminokit Laboratories, Inc. et. al.,* 2019 WL 479204, (D. Colo. February 7, 2019).

Cases of Interest

Fiduciary Liability Policy Does Not Cover Claims Arising from Failure to Pay Premiums

This decision is worth highlighting as a reminder that court's routinely take the position that professional liability policies do not provide coverage for contractual obligations of an insured.

Here, the insured was a California company that offered certain employment benefits to its employees. The Controller of the insured was responsible for informing employees about their eligibility for, and the scope of, the employer offered benefit plans, as well as for enrolling employees. He was also responsible for deducting the appropriate amounts from employees' paychecks and paying policy premiums.

Unfortunately, the Controller failed to make the required premium payments to maintain and renew the employee benefit plans, and never notified employees that coverage had lapsed. This resulted in employees filing demands with the company for benefits they should have been entitled to. The employee demands were then submitted for coverage under two fiduciary liability policies purchased by the company; however, coverage was denied and this case was filed challenging the legality of the denial.

The fiduciary policies in question here both conditioned coverage on an 'Employee Benefits Injury' or a 'Wrongful Act'. The court summarized the issue before it as whether the benefits due to the employees under the plans were amounts the insurer was legally obligated to pay as a result of a Wrongful Act, or if they were instead amounts the insured company was legally obligated to pay by contract, independent of any Wrongful Act.

Siding with the insurer, the court held the insured was obligated to pay the underlying claims because of its contractual obligations to employees rather than because of a Wrongful Act on the part of the Controller. "The fact that the breach of contractual obligation may itself have been negligent does not render it a covered wrongful act." Expanding upon this rationale, the court explained: "[e]ven in the absence of an express exclusion, courts have held that a claim alleging breach of contract is not covered under a professional liability policy because there is no 'wrongful act' and no 'loss' since the insured is simply being required to pay an amount it agreed to pay." Thus, the denial of coverage was upheld based on the policies only affording coverage for breach of fiduciary duties or negligent, tortious acts. *Erickson-Hall Construction Co. v. Scottsdale Insurance Co., et. al.*, 2019 WL 719204 (S.D. Cal. February 20, 2019)

D&O Filings, Settlements and Other Developments

D&O Filings

- As we have previously reported, D&O Federal Class Action Securities Claims have been elevated for three straight years
    - The 2018 annual total of 403 filings exceeded the 2010-2015 annual average of 173 filings by 133%
    - At the same time, over the last eight years, the number of U.S. public companies has *decreased* by 17%
- In 1Q2019, filings continued at an elevated level, with 98 Federal Class Action Securities Claims having been filed
    - This implies an annualized number of 392 filings, which would be in-line with 2018
    - At this rate, **approximately 1 in 10 public companies are being sued for securities fraud**
- SEC enforcement activity also remained elevated in the first half of fiscal 2019, with 52 new actions against public companies

D&O Settlements

- 78 Federal Class Action Securities Claim settlements were approved in 2018, versus 81 in 2017
- Average settlement size increased substantially from $18.2 million (2017) to $26.8 million (2018)[1]
    - Median settlement size also increased dramatically from $5.1 million (2017) to $11.3 million (2018)
- Settlement sizes for other D&O claims (i.e., derivative) have also been increasing, as have defense costs

Other Developments and Considerations

- With D&O litigation remaining elevated, carriers continue to push for rate increases on primary and low excess layers.
    - Price increases have been most noticeable for small cap companies and companies in challenging sectors.
    - Companies considering an IPO can expect to see dramatically different terms versus 3-6 months ago. Retentions and pricing have been increasing noticeably, and carriers have also begun to cut back on limit deployment.
    - Excess 'Side A' pricing remains noticeably more competitive than 'ABC' 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.
- In May, the SEC voted to advance a proposal that would exempt certain lower-revenue public companies from having to obtain an attestation of their internal control over financial reporting (ICFR) from an independent auditor. This proposal is subject to a 60-day waiting period.

[1] *2018 average settlement size does not include one settlement which totaled $3 billion*

Sources: Cornerstone Research; Stanford Law School

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About IMA

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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.

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