QUARTERLY UPDATE

Q2 2022

IMA EXECUTIVE RISK SOLUTIONS

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SEC Update

Fifth Circuit Finds SEC Enforcement Proceedings Subject to Seventh Amendment Right to Trial by Jury

In May, the Fifth Circuit Court of Appeals issued its decision in *Jarkesy v. SEC*. Its impact and the implications of its holding will be felt for some time, likely until the U.S. Supreme Court rules on the conflict that now exists regarding the SEC's ability to have enforcement proceedings heard by its own Administrative Law Judges ("ALJs"). The authority to bring enforcement proceedings before ALJs, as opposed to the cases being tried in federal court by way of a jury trial, has been upheld by numerous other Circuit Courts. The SEC has yet to announce whether it will appeal the decision.

In 2014, an ALJ found Jarkesy liable for fraud and issued him a fine of $300,000. It further ordered disgorgement of $685,000 and barred him from engaging in various securities industry activities going forward. The Commission subsequently affirmed the ALJs ruling, which was then appealed to the Fifth Circuit Court of Appeals. Jarkesy's appeal challenged whether the adjudication of securities fraud cases by ALJs was in violation of the Seventh Amendment to the U.S. Constitution, guaranteeing the right to a jury trial in civil cases where the amount in dispute exceeds twenty dollars. Taking aim at the entire enforcement system created by Congress under the 2010 Dodd Frank Wall Street Reform and Consumer Protection Act, the split panel held the Seventh Amendment applicable to such claims and went even further in finding Congress failed to provide an intelligible principle by which the SEC can exercise its delegated powers. As such, the delegation of authority to decide whether to file enforcement actions in federal court, *or* before an ALJ violates Article I's vesting of all legislative powers in Congress. Lastly, it found the statutory removal restriction on SEC ALJs in violation of the Take Care Clause in Article II.

The court's rationale on its first ruling was that since fraud was actionable under common law principles, fraud actions under the securities statutes are essentially no different. While admitting that the Seventh Amendment doesn't prohibit Congress from assigning the factfinding function and initial adjudication to an administrative forum, the court found Congress cannot convert any sort of action into a 'public right' not susceptible to the Seventh Amendment simply by codifying it in federal law. Next, it found the delegation of discretion whether to bring enforcement actions in federal court *or* before ALJs to be an improper delegation of legislative power. By allowing the SEC to make that decision, rather than mandating a particular method by which the SEC must act, Congress improperly delegated its Constitutional duty.

Lastly, it held the statutory removal restriction for SEC ALJs was also unconstitutional because it

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insulated those positions from the President by two layers of for-cause protection, thereby improperly limiting the President's powers.

Where things go from here for SEC enforcement actions remains a big question. As noted above, this will not be the final word on the matter given the implications of the decision.

To be blunt, this decision represents the Fifth Circuit's attempt at dismantling the enforcement regime established under Dodd-Frank, plain and simple. If the case is not overturned, massive changes in how the SEC operates will be necessary, as well as bringing into question all prior adjudications undertaken by ALJs. Updates will be provided in this publication as they become available. *Jarkesy, Jr. v. Securities & Exchange Commission*, 2022 WL 1563613 (5th Cir. 2022).

Cases of Interest

Excess Insurer's Divergent Coverage Position Rejected by Court

This case involved a second excess D&O insurer attempting to assert coverage defenses not raised by either underlying insurer on the program. Following the initiation of an investigation by the SEC wherein subpoenas were served on the insured and where numerous lawsuits were filed after they were forced to restate their financials, the insured sought coverage from its insurers.

The primary insurer accepted coverage of both the securities and derivative litigation and further agreed to fund fifty percent of the expenses incurred in responding to the subpoenas served by the SEC based on the fact that the same materials would be discoverable in the covered litigation. After the first layer was exhausted, the first excess insurer agreed to fund forty percent of the overlapping discovery costs. When the second excess insurer's layer was triggered, it sought to deny coverage. In doing so, it asserted a 2014 letter from investors provided to the insurers as a potential claim was the same as alleged in the litigation, meaning coverage was unavailable under the subsequent program.

The second excess insurer also took issue with amounts paid by the underlying insurers for costs incurred in responding to the SEC. Its argument essentially being that the underlying insurers should not have paid those costs, which led to premature exhaustion of the underlying policies.

In a terse opinion finding for the insureds, the court rejected all of the positions taken by the excess insurer. It found the 2017 litigation to arise from a restatement of financials and the change in accounting practices that mandated the restatements. While the 2014 letter tendered as a potential claim included concerns regarding improper accounting methods and internal controls, it was far too vague to conclude the subsequent litigation was identical in nature to the prior allegations.

"The record before the Court reflects that the plaintiffs in the 2017 Securities Litigation did not allege the same underlying accounting deficiencies as those described in the [2014] letter." With respect to the excess insurer's attempt at second-guessing the amounts paid out by the underlying insurers for costs incurred in responding to the SEC, the court rejected it out of hand. With the underlying policies exhausted, the second excess insurer's policy was triggered, and it had no grounds upon which to challenge the underlying insurers' coverage decisions that resulted in exhaustion through amounts paid out in defense costs.

As we've mentioned before in these pages, the structure of a D&O program must take into account

Cases of Interest

Excess Insurer's Divergent Coverage Position Rejected by Court

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the claims history of all insurers on the tower. Being forced to litigate over coverage after the primary and first excess insurers pay their limits is something no insured should ever have to experience. A well-vetted line-up of carriers with a strong claims-paying history is of utmost importance when constructing a liability insurance tower. *Amtrust Financial Services, Inc. v. Liberty Insurance Underwriters, Inc.*, 2022 WL 980299 (D. Del. March 31, 2022).

Cases of Interest

Failure to Allocate Covered/Uncovered Portions of Settlement Deprives Insured of Coverage

A decision from earlier this year serves as a reminder that defense counsel must be aware of insurance coverage implications before finalizing the terms of any settlement.

After an employee of the insured filed suit following his termination, the matter was tendered to the insured's employment practices liability insurance policy. In addition to alleging wrongful termination, claims were pursued under the operating agreement that detailed the employee's ownership stake in the company.

The insurer accepted coverage for claims arising out of employment related misrepresentations but denied coverage for claims brought alleging breach of the operating agreement and breach of fiduciary duty. The insurer provided a defense under a reservation of rights but maintained that indemnity was unavailable based on the causes of action pleaded.

Ultimately, the insurer agreed to fund a portion of the settlement that represented what its cost of defense was likely to entail, but nothing more. The insured then brought suit challenging this coverage position.

Noting that Florida law requires the party seeking coverage for a settlement to bear the burden of proving coverage, and that an insured's inability to allocate covered and uncovered parts within a settlement will preclude recovery, the court looked to the terms of the settlement itself to decide the matter. Finding that the settlement was a global resolution and mutual release of all disputes that did not allocate any portion of the lump sum to any specific claims or causes of action, the court held in favor of the insurance company.

Because the operating agreement did not constitute an employment agreement, claims brought under it fell outside of coverage and no indemnity obligation existed. The takeaway here is that in cases involving coverage disputes with the insurer, it is incumbent upon defense counsel to structure settlements in a way that will not deprive their clients of insurance coverage

Absent any way of identifying covered and uncovered portions of a settlement, it deprives the insured of coverage for the entire amount. *Around the Clock A/C Service, LLC v. Travelers Casualty & Surety Co.*, 2022 WL 678799 (S.D. Fla. January 31, 2022).

Cases of Interest

Opioid-Related Derivative Suit Settles for $124 million

Following the denial of Cardinal Health's Motion to Dismiss opioid-related litigation in early 2021, the company announced an agreement to settle the claims in Q2 2022. The settlement will be funded entirely from Cardinal's D&O insurers and represents yet another example of a massive payout relating to claims for breach of the duty of oversight against a company's board of directors. While derivative claims alleging breach of the duty of oversight have had limited success in the past, the background of this matter stands as an example of how a company's directors will be held to account if they are unable to remedy deficiencies over an extended period of time.

In February 2021, a federal district court in Ohio denied Cardinal's Motion to Dismiss. Applying Ohio law, the court noted that liability hinges on whether the directors ignored 'red flags' warning of compliance problems that were actually brought to their attention.

In this case, going all the way back to 2007, Cardinal entered into a series of consent agreements with the Drug Enforcement Agency for violations of the Controlled Substances Act. The first was executed in 2008 and the second consent agreement was executed in 2012. Numerous lawsuits followed, most notably from state attorneys general wherein Cardinal admitted to violations of the CSA in resolving the cases.

In 2018, both chambers of Congress held hearings and conducted investigations that concluded in the issuance of the "McCaskill Report" which found Cardinal consistently failed to meet its reporting obligations. While lawsuits and bad publicity continued for over a decade, it was only in 2018 that the board created a committee to assist its oversight responsibilities regarding CSA compliance. In 2019, shareholders initiated derivative litigation.

On May 25, 2022, the settlement was announced, wherein Cardinal agreed to pay $124 million as well as an additional twenty-five percent to plaintiffs' counsel as an aggregate fee and expense award. The settlement remains subject to court approval. As noted above, plaintiffs' motion indicates the amount is to be paid by Cardinal's D&O insurers. It represents one of the largest shareholder derivative settlements ever and may eventually be considered somewhat of a demarcation point in time when insurers can no longer rely on derivative actions being resolved for anything less than significant sums of money if the facts are not in their favor.

In the context of Boeing agreeing to pay $237.5 million to resolve its 737 Max derivative claims along with McKesson settling its opioid-related derivative claims for $175 million, although claims for breach of the duty of oversight may be hard to prove, they are a very real possibility. *In re Cardinal Health, Inc. Derivative Litigation*, 518 F.Supp.3d 1046 (S.D. Ohio February 8, 2021).

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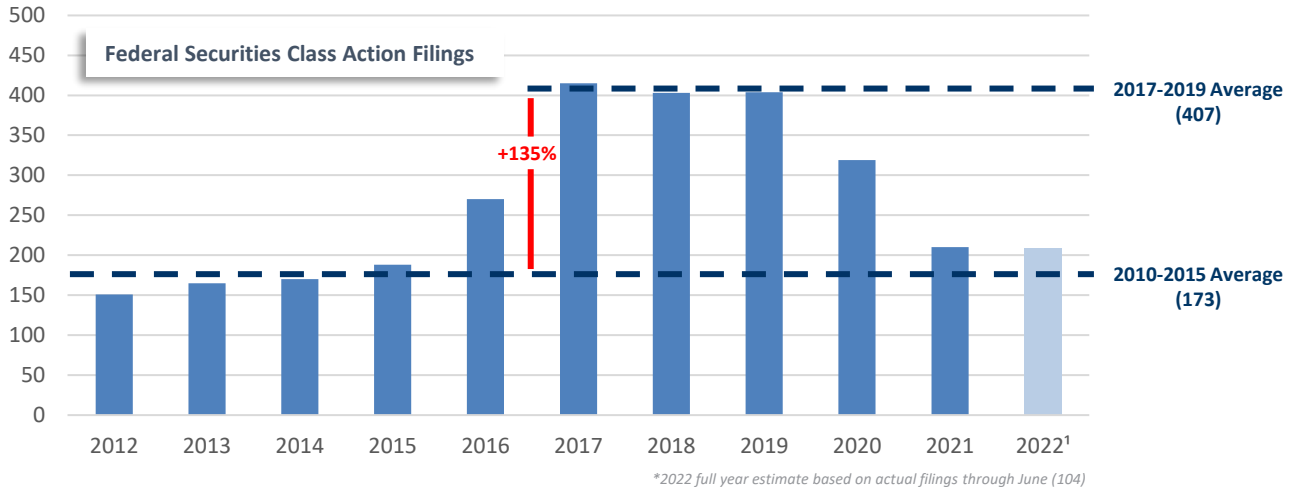
D&O Filings

- As we have previously reported, D&O Federal Securities Class Action Claims decreased noticeably over the last two years.
    - Filings were down ~35% in 2021, yet still above historical norms.
- In 1H 2022, filings held steady compared to 2021, with 104 total Federal Securities Class Action Claims (v. 108 in 1H21).
    - This implies an annualized number of 208 filings, compared to the 210 filings we saw in 2021.



D&O Pricing and Outlook

- With D&O litigation having declined each of the last two years, dismissal rates remaining elevated, new capacity entering the marketplace, and a slightly improved broader economic outlook versus one year ago, D&O pricing for recent renewals has generally been more favorable than year ago levels, particularly on higher excess levels.
    - Companies considering an IPO or de-SPAC transaction can continue to expect elevated pricing and retentions, but both of these are also much more favorable than year ago levels.
    - D&O pricing is also still dependent on a company's specific situation, so messaging the risk profile in the right way to D&O underwriters remains important.
- An additional contributing factor to the much improved pricing environment is the sharp decline in the number of IPOs and de-SPAC transactions in 2022, which has created a "hole" in D&O carrier budgets that must be filled.
- As we look forward over the remainder of 2022 and into early 2023, we are optimistic that the trends we have seen over the last few months will continue to take hold, with additional pricing improvement and capital deployment.

Key Contacts

Brian R. Bovasso
Managing Director
IMA Executive Risk Solutions
303.615.7449
brian.bovasso@imacorp.com

Travis T. Murtha
Director of ERS Claims
IMA Executive Risk Solutions
Legal & Claims Practice
303.615.7587
travis.murtha@imacorp.com

Daniel Posnick
Transactional Liability Leader
IMA Executive Risk Solutions
303.615.7747
daniel.posnick@imacorp.com

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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.