QUARTERLY UPDATE

Q3 2022

IMA EXECUTIVE RISK SOLUTIONS

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Legislative Update

Inflation Reduction Act's 1% Excise Tax on Stock Repurchases Goes Into Effect in 2023

A last minute addition to the Inflation Reduction Act signed into law on August 16, 2022 will impose a 1% excise tax on stock repurchases by publicly traded domestic corporations. The stated purpose of the tax is to encourage investment in workers and the business in general, rather than enriching management and shareholders. While such a provision was originally included in the Build Back Better legislation, questions remain about its scope and applicability. As a result of the very broad wording used in the statute, it will very likely implicate many transactions beyond typical stock buyback plans (any "economically similar" transactions), including certain redemptions of privately held preferred stock, leveraged take-private acquisitions and business combinations effectuated as part of a de-SPAC transaction.

'Covered corporations' under the Act are those whose stock trades on established markets (i.e., NYSE, NASDAQ, London Stock Exchange) and there is no minimum market-cap requirement, meaning it applies to micro-cap companies as well. If a 'specified affiliate' repurchases the covered company's stock, defined to include a corporation or partnership directly or indirectly controlled by the covered corporation, the tax would also be applicable. Certain surrogate foreign corporations will also qualify.

The Secretary of the Treasury is tasked with specifying what constitutes an 'economically similar' transaction under Treasury Regulations that have yet to be issued. Whether the repurchased shares are cancelled, retired or held as treasury stock is immaterial for purposes of applicability.

Interestingly, since it applies to redemptions of all stock of covered corporations, the tax will be applicable to redemptions of non-publicly traded classes of stock. Stock redemptions occurring as part of a reorganization will need to be scrutinized as well, especially with respect to SPAC redemptions. In the scenario where a SPAC fails to enter into a business combination and/or chooses to liquidate, it appears this tax would be applicable. Regulations to be issued by the Secretary of the Treasury will hopefully clarify this, as it could lead to liquidity issues if the SPAC's governing documents prohibit funds held in trust from being used for payment of tax liabilities.

Exceptions that can be employed to reduce or eliminate the consequences of this tax include issuances via a private investment in public equity (PIPE), pursuant to warrant exercises, issuances to target shareholders, founders, sponsors, or employees under a long-term incentive plan, or any other issuances in the same fiscal year.

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Other exceptions to the legislation include: (i) reorganizations where no gain or loss is recognized, (ii) the contribution of repurchased stock, or an amount equivalent thereto, to employer-sponsored retirement plans or employee stock ownership plans, (iii) repurchases that do not exceed $1 million in total value, (iv) the repurchase of stock by a dealer in securities in the ordinary course of business, (v) repurchases of stock by a regulated investment company or real estate investment trust, or (vi) repurchases treated as a dividend.

Additional guidance from the Treasury Department will be necessary to understand the full impact of this tax.

Cases of Interest

Criminal Trial of Former Uber Executive Highlights the Importance of D&O

The criminal conviction of Joe Sullivan, former Chief Information Security Officer (CISO) of Uber, is a story worth paying attention to. Sullivan was let go by Uber in 2017 after being accused of mishandling a security incident the year prior. Criminal charges were levied against him in 2020 by the same U.S. Attorney's office he formerly worked for, after new leadership at Uber assisted in building a criminal case against him. On October 5, 2022 Sullivan was found guilty for obstruction of justice and actively hiding a felony. The verdict is likely to have widespread implications for cybersecurity professionals as well as the insurers writing cyber coverage. An appeal is highly likely, so this saga is more likely than not far from over.

The charges in the Uber case arose out of an incident where hackers gained access to personal records of 50 million Uber subscribers and 600,000 drivers. The hackers were referred to Uber's bug bounty program and the breach was never disclosed publicly. Prosecutors successfully argued the breach was outside the scope of the bounty program, meaning the company was obligated to disclose what had happened. The other part of the fact pattern that did not bode well for Sullivan was that the Federal Trade Commission was already investigating Uber for a prior breach when this one occurred.

In the years since this breach occurred, businesses and insurers alike have begun regularly paying ransoms to hackers. Insurance coverage for incidents of hacking, data breaches or data held ransom has become commonplace, if not an outright necessity. Personal liability for actions taken in response to a data breach is something new, however, and questions surrounding the protection afforded by D&O policies comes to the forefront. While the details of how Mr. Sullivan funded his defense are not public, he ended up suing Uber to pay his legal fees. A private settlement was reached, the details of which remain confidential. This case is therefore likely to put information security professionals on notice of the need to understand the D&O coverage in place at their organization.

For criminal matters, the majority of the coverage available under a D&O policy would be in the form of defense cost reimbursement either directly to the individual defendant (if no corporate indemnification/advancement is being provided), or to the Insured Organization excess of the per-Claim retention (when indemnification/advancement is available).

Cases of Interest

Criminal Trial of Former Uber Executive Highlights the Importance of D&O

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Other coverage potentially available in a well structured D&O program includes Asset Protection Costs (usually a sub-limited amount of funds available to oppose a regulator's efforts to seize personal assets/real property) and Personal Reputation Expenses (hiring a crisis firm post-crisis event to mitigate adverse reputational effects from a crisis). In circumstances like those here, as long as the insured has made no admission of guilt, defense coverage should remain available until a final adjudication following all available appeals affirms the findings underpinning the conviction. In practice, it means corporate officers need to both understand the scope of coverage afforded under their cyber coverage for the company, and the D&O as it relates to their potential liability for actions taken in such a capacity.

Cases of Interest

Diversity, Equity & Inclusion (DEI) Policies Continue to Attract Litigation

In late August, Starbucks and its CEO Howard Schultz were named as defendants in a lawsuit targeting the company's DEI policies. This particular suit serves as an example of how companies face the risk of litigation no matter what position they side with on a particular issue.

In October 2020, Starbucks announced the adoption of policies calculated to showcase its commitment to DEI. The company is now being forced to defend them in court against allegations that the policies violate state and federal civil rights and anti-discrimination laws. The lawsuit was preceded by an open letter to the directors and officers of Starbucks earlier in the year wherein a demand was made for retraction of the policies. After refusing to do so, litigation was filed.

This suit was initiated by the National Center for Public Policy, a conservative non-profit think tank that is also a Starbucks shareholder. Preliminary and permanent injunctions are being sought, along with a declaration that the DEI policies violate state and federal law. Damages for breach of fiduciary duty are also being sought, which would flow back to the company.

Claimants allege the policies require Starbucks to discriminate based on race in employment decisions, compensation offered to employees and its selection of third party vendors.

Claimants likely found strength in the fact that seventeen states have now adopted or proposed anti-ESG legislation. As a reminder, ESG stands for Environmental, Social and Governance. It refers to the three key non-financial factors used to measure an entity's values. The stated goals of anti-ESG legislation are to limit the ability of state governments, including public retirement plans, to do business with entities that use ESG factors in their investments or business practices.

As these issues relate to corporate risk, it reinforces the necessity of each and every policy a company publicly announces being thoroughly vetted in advance for the litigation risk it may present. It is not surprising that new policies will be challenged in court, but what this case represents is that sometimes you're damned if you do and damned if you don't.

Cases of Interest

Dissension Between Judges Causes Confusion for Litigants

If you thought this piece was going to be about Florida and the appointment of a special master, you may have missed what transpired in two Ohio federal district courts over the last few months. Parallel cases pending in both the northern and southern districts of Ohio arising out of the FirstEnergy bribery scandal are facing an unprecedented dilemma after one judge refused to stay the case before his court after a global settlement to resolve all litigation against the company was tentatively reached.

The dispute at the heart of both cases involved a bribery scandal that led to the indictment of the former Speaker of the Ohio House of Representatives. In July of 2021, FirstEnergy entered into a deferred prosecution agreement (DPA), admitting it conspired with public officials and other individuals in exchange for legislation that would benefit the company and fund the maintenance of its aging nuclear power plants. Approximately $60 million in bribes were paid in furtherance of this scheme. FirstEnergy agreed to pay a fine of $230 million as a result of the DPA.

As you might expect, a rash of lawsuits were filed upon revelation of the bribery scheme. Shareholders filed derivative lawsuits against current and former directors and officers in both the northern and southern districts of Ohio. Nine cases were consolidated in the southern district; however, Judge John R. Adams of the northern district refused to transfer the case filed in his court to the southern district. After the announcement of a tentative settlement for $180 million (to be funded entirely by insurance), Judge Adams issued an order seeking the identity of individuals involved in the actual payment of bribes. When counsel for plaintiffs refused to answer on the basis that those identities were only discovered during confidential mediation, the judge hinted that he may seek to appoint new counsel to represent plaintiffs and threatened the attorneys with sanctions.

Despite the southern district granting preliminary approval of the above-referenced settlement, Judge Adams followed through on his threat and appointed new counsel to represent plaintiffs in August. Final approval of the settlement was granted in late August. The order carefully scrutinized the fairness of the proposed settlement and corporate therapeutics agreed upon. While reducing the fee award to plaintiffs' counsel from $48.6 million to $36 million, the court dismissed the concerns raised by Judge Adams related to forum shopping, noting the first action was filed in the southern district, not Adams' court. In an act of comity, the southern district left it up to Judge Adams to decide how final entry of final approval affects ongoing proceedings before Judge Adams.

Cases of Interest

Dissension Between Judges Causes Confusion for Litigants

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It remains unclear what Judge Adams' end game is here. It is not the first time he has refused to respect the authority of other courts, but how much additional time and money his actions may cost litigants remains to be seen. If he refuses to dismiss the case in his court, appellate relief from the 6th Circuit is the likely avenue of recourse. The 6th Circuit Court of Appeals is no stranger to Judge Adams, having previously ordered him to undergo a mental health evaluation before retracting the order following continued obstreperous conduct. From a practical standpoint, his personal crusade purportedly on behalf of Ohioans affected by the FirstEnergy bribery scheme only creates more work and confusion for the parties involved. It seems more likely than not it will only prolong the dispute, costing everyone more in the long run. In sum, this is an unfortunate reminder that when federal judges do not respect one another, litigants end up bearing the burden.

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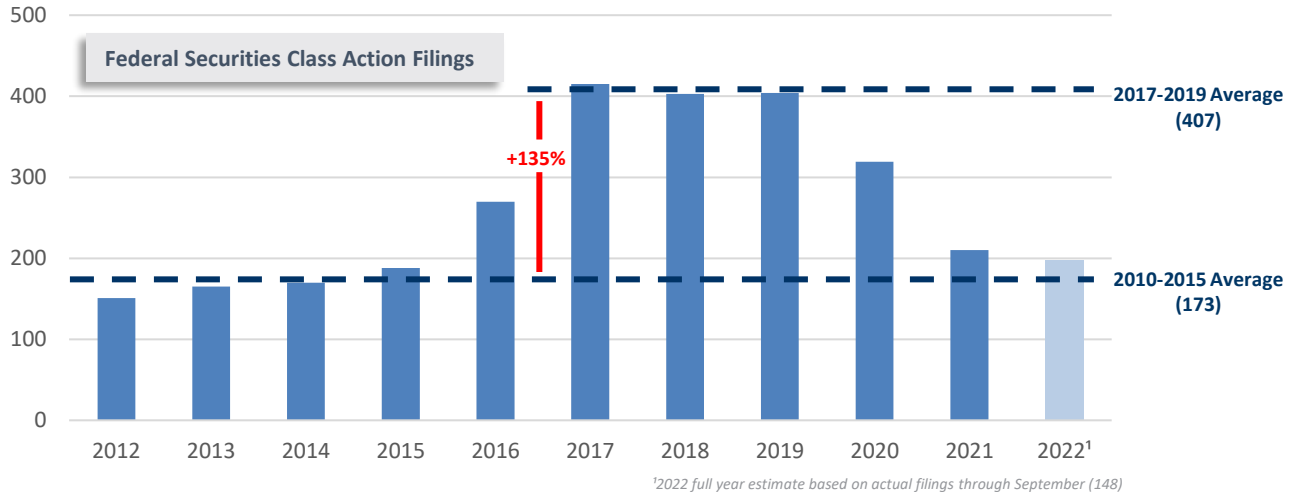
D&O Filings

- As we have previously reported, D&O Federal Securities Class Action Claims decreased noticeably over the last two years.
- In 1H 2022, filings held steady compared to 2021, with 104 total Federal Securities Class Action Claims (v. 108 in 1H21).
- Filing rates through September 2022 imply an annualized number of 197 Federal Securities Class Action Claims.
    - Filings slowed down a bit in 3Q22, and an annual total of 197 would represent a YoY decrease of 6.6%.



D&O Pricing and Other Developments

- With D&O litigation having declined each of the last two years (and on track for a third), dismissal rates remaining elevated, and new capacity entering the marketplace, D&O pricing for recent renewals has generally been more favorable than year ago levels, most noticeably on excess layers of insurance.
    - 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 crucial.
- 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.
- One item we continue to watch closely is the shifting focus of the Securities and Exchange Commission (SEC). In its most recent fiscal year, the SEC obtained a record $6.4 billion in sanctions, which is ~40% higher than the previous record.

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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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