D&O liability: Looking back at 2018 & ahead to 2019

THE GYRATIONS OF THE MARKET AND CHANGES IN REGULATORY POLICY MAKE THE FUTURE OF D&O LIABILITY INSURANCE AND UNDERLYING EXPOSURE AREAS TO WATCH DURING 2019.

BY WILLIAM GORMAN PASSANNANTE

AS THE year turns from 2018 to 2019, a look back at developments in D&O liability insurance and underlying exposure helps put events into perspective.

ELEPHANTS DON'T FIT IN MOUSEHOLES

Increased D&O liability exposure flowed from the opinion in Cyan, Inc. v. Beaver County Employees Retirement Fund [No. 15-1439 (U.S. Supreme Court, March 20, 2018)], which upheld the plaintiffs' right to bring certain securities class actions in state courts. Since the dawn of securities regulation in the U.S., both state courts and federal courts have had jurisdiction over securities cases. Federal securities law had its genesis in two statutes: the Securities Act of 1933 and the Securities Exchange Act of 1934. The Cyan Court noted that "[t] he 1933 Act required companies offering securities to the public to make 'full and fair disclosure' of relevant information." The 1933 Act authorizes both federal and state courts to exercise jurisdiction over suits alleging violation of the Act and bars the removal of such suits from state to federal court. The Cyan Court also observed that the 1934 Act functions differently: The statute "regulated not the original issuance of securities but instead all their subsequent trading, most commonly on national stock exchanges." The 1934 Act also handles jurisdiction differently: "Congress determined that all those suits should fall within the 'exclusive jurisdiction' of the federal courts."

In a demonstration that unintended consequences often follow changes, Congress amended the securities laws on two occasions, each of which was aimed at perceived abuses in securities class actions. The Private Securities Litigation Reform Act of 1995 (PSLRA) made procedural changes applicable only in federal court, the unintended consequence of which was to induce plaintiffs to bring more actions in state court and under state law to avoid the PSLRA. In response to that rise in state class action activity, Congress again amended the securities laws embodied in the Securities Litigation Uniform Standards Act of 1998 (SLUSA). Cyan argued that SLUSA barred state court jurisdiction of certain class actions alleging 1933 Act violations.

A unanimous Supreme Court held that the SLUSA did not eliminate state court ability to adjudicate class actions alleging 1933 Act violations, starting with the text of the law: "The statute says what it says — or perhaps better put here, does not say what it does not say. State-court jurisdiction over 1933 Act claims thus continues undisturbed." Addressing the SLUSA more broadly, Justice Kagan notes that Congress does not implicitly make radical changes, or "to use the more general (and snappier) formulation of that rule, relevant to all 'ancillary provisions,' Congress does not 'hide elephants in mouseholes.'" Thus, Cyan's attempt to reduce D&O liability exposure by limiting plaintiffs' access to state court to bring 1933 Act cases did not succeed, increasing D&O liability exposure on the margin.

ENVIRONMENT AND SUSTAINABILITY

Companies with "sustainability" as part of their mission should exercise reporting and disclosure with care. Allegations with regard to sustainable yield have been used to argue that merchantable inventory and financial condition were misstated.

Rayonier Inc. was sued in a securities case by the Pension Trust Fund for the Operating Engineers and the Lake Worth Firefighters' Pension trust Fund. The case alleged that Rayonier and other defendants made false and misleading statements relating to Rayonier's forest harvesting practices and its reported merchantable timber inventory, along with certain financial results. The claims asserted violations of 10(b) and 20(c) of the 1934 Act. The complaint alleged that the price of Rayonier common stock was artificially inflated as a result of the allegedly misleading statements, and it declined when the truth was revealed. The plaintiffs argued that Rayonier's statements regarding sustainable harvesting of millions of acres of timber were misleading. The parties to the case ultimately reached an agreement to settle for $73 million. The settlement was funded by D&O insurance, Reuters reported.

Given this template, one might expect future assertions of "carbon neutral" operations would lead to similar claims. The environmental sustainability of operations is a source of future D&O liability for policyholders and their insurance companies.

IMPROPER ATTEMPTS TO AVOID COVERAGE FOR SUBPOENAS

Years ago, a well-known and well-regarded judge remarked to me in the courtroom off the record that it seemed to him that insurance companies were in the business of collecting premiums and not paying claims. The approach that D&O insurance companies have taken for years to coverage for costs related to subpoenas brings that observation to mind.

In Astellas US Holdings, Inc. v. Starr Indemnity and Liability Co. [No. 17 CV 8220 (N.D. Ill., May 30, 2018)] the court addressed the tired argument that many policyholders face when presenting a claim for defense costs to their D&O insurance company. In this case, the insurance company argued that it would be "absurd" to cover subpoenas because the policies are supposed to cover liability from alleged wrongdoing. This despite the fact that in the policy in question, "Claim" is defined to include "written demand for monetary, non-monetary or injunctive relief," as well as "formal civil, criminal, administrative or regulator investigation … commenced by the filing or issuance of a notice of charges, formal investigative order or similar document identifying [an] Insured Person against whom a proceeding … may be commenced."

The Court addressed the argument as follows: "But I disagree with [the insurance company's] characterization of the subpoena. The broad definition of a 'Claim,' which includes overlapping subparts, indicates that the policy was designed to cover something like the subpoena — which is a demand for relief in response to an accusation of wrongdoing. Thus, the 'result' in this insistence — that [the insurance company] may have to cover plaintiffs' costs related to the subpoena — is not absurd, it is precisely what the policy intended."

Another policyholder forced to fight to obtain their already-paid-for insurance coverage.

A LOOK AHEAD TO 2019: BREXIT RISKS

The contours of Brexit are far from known, and 2019 will bring more clarity. Jay Clayton, chairman of the Securities and Exchange Commission has let it be known that the SEC is focused on disclosures about the risks that Brexit presents to the investing community.

The Wall Street Journal reported that Clayton recently told a conference audience, "My personal view is that the potential impact of Brexit has been understated," and "I would expect companies to be looking at this closely and sharing their views with the investment community." He also said, "I want to see the disclosure, to the extent that it's material and appropriate, gravitate" toward "a thoughtful analysis of the potential risks posed by a so-called hard Brexit."

As the Brexit process itself develops, analysis of impact and disclosure of attendant risk will take place in 2019.

The gyrations of the market and changes in regulatory policy will make the future of D&O liability insurance and underlying exposure areas to continue to watch during 2019.

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