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Managing the Risk of Emerging COVID-19 Securities Liabilities With D&O Insurance

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With a new year and the introduction of multiple vaccines, there is much hope that the end of the COVID-19 pandemic is in sight. Nevertheless, the pandemic will have wide-ranging consequences far beyond its end date.

For businesses, these consequences already have included and will continue to include exposure to coronavirus-related securities liabilities. Indeed, in 2020, there were more than 20 class-action lawsuits relating to COVID-19. These suits have asserted varying allegations but have included allegations that the defendants failed to disclose pandemic-related risks, failed to take proper precautions to prevent pandemic-related losses, or made misrepresentations regarding anticipated developments resulting from COVID-19.

At the same time, there already has been an uptick in enforcement activity by the Securities and Exchange Commission (SEC). Although many of the SEC's investigations and enforcement actions have pertained to outright fraud, some of the SEC's latest actions indicate a shift toward a more nuanced analysis of whether companies provided a full and fair assessment of their financial health. Most recently, on December 4, 2020, the SEC reached a settlement with The Cheesecake Factory pertaining to claims that the company made materially misleading disclosures about the impact of COVID-19 by, among other things, excluding expenses attributable to corporate operations from its claim of sustainability.

These new exposures present unique challenges for organizations. Given the frantic pace and unanticipated impact of COVID-19, businesses often have been forced to make decisions and disclosures on the fly without the benefit of full information. In light of the enhanced scrutiny of corporate disclosures, issuers would be well advised to take the opportunity now to review their internal controls and make any needed improvements to ensure that disclosures are thoroughly vetted prior to dissemination. In addition, issuers may want to consider taking a more liberal approach with respect to what items may be deemed material and worthy of disclosure, particularly with respect to risk factors and management's discussion and analysis of financial condition.

To help manage the risk, companies also should be considering the protection provided (or not provided) by their directors and officers (D&O) liability insurance policies. D&O policies generally provide coverage for claims made against the company and its employees for alleged wrongful acts committed in connection with business operations. For publicly traded companies, the coverage for the entity often is limited to coverage for specific types of claims, like securities claims.

With an aggressive plaintiffs' bar and an active SEC expected with the incoming Biden administration, you should review the following issues in connection with your organization's insurance program:

1. **Does your insurance policy cover costs for investigations?** Investigation costs commonly exceed even the cost of defending or settling a lawsuit. Most D&O insurance policies are written on a claims-made basis, meaning a "claim" must be made during the policy period in order to trigger coverage. The definition of "claim"

undoubtedly will include a civil complaint, but it may also include a written or oral demand for monetary damages or equitable relief, or a civil investigation demand. Thus, depending on how "claim" is defined, it may cover the initial costs in responding to a government inquiry and other investigation costs. Some insurance companies also offer endorsements that provide coverage for costs and expenses incurred in responding to a regulatory investigation that has not yet developed into a lawsuit. These endorsements, however, may be subject to a small sublimit, so it is important to consider the adequacy of this coverage.

2. **How will a corporate bankruptcy or insolvency affect your insurers' coverage obligations?** Given the devastating impact of COVID-19, the unfortunate reality is that many businesses must consider the risk of bankruptcy or insolvency. Businesses should avoid language in D&O policies that limit insurers' coverage obligation in the event of bankruptcy. For instance, companies should seek language that expressly provides that the bankruptcy of the insured does not terminate the policy or otherwise excuse an insurer's duties. As another illustration, although insured-versus-insured exclusions typically bar coverage only for claims brought by or on behalf of one insured against another insured, some insurers have relied on this exclusion to deny coverage for claims by a trustee or following a bankruptcy. Many courts have rejected this position, but during the underwriting and placement of D&O insurance, the best practice is to seek endorsements expressly clarifying that the insured-versus-insured exclusion does not apply to claims by trustees, receivers, or creditors' committees.

3. **How can your company preserve coverage for anticipated claims if restrictions are being added to replacement insurance policies?** Given a hardened insurance market, many companies unfortunately will find that restrictive terms, including lower limits, higher deductibles, and new exclusions, are being added to their replacement D&O policies. Proactive businesses may be able to blunt the effects of these restrictions by taking measures to preserve coverage under existing policies for anticipated claims. While D&O policies typically provide coverage only for claims made during the policy period, "notice of circumstances" provisions in D&O policies provide a common exception to this rule. These provisions allow policyholders to report circumstances that may lead to a future claim. If the anticipated claim, in fact, is asserted after the expiration of the policy period, the claim will be treated as having been made at the time the notice of circumstances was given. In situations where insurers are adding restrictions that will limit coverage for anticipated claims, this can be an important protection. However, it should be exercised in consultation with your insurance broker and coverage counsel so your company is complying with all policy requirements and understands the potential ramifications.

4. **Does your company have a plan for when a claim is made?** It should go without saying that policyholders need to provide prompt notice to their insurance carriers after a claim is made, but what constitutes a "claim" is not always obvious. In some instances, even an oral demand made via telephone call or a request to extend the statute of limitations may require notice. Policyholders should anticipate these issues by having a plan in place for reporting claims to insurers. In developing such a strategy, businesses should work with their brokers and insurance recovery counsel to evaluate (1) what insurance policies and/or indemnification provisions apply, (2) when the company is required to provide notice, (3) how notice requirements are satisfied under applicable insurance policies, (4) who is responsible for evaluating coverage for claims and losses, and (5) who is responsible for providing notice. In providing notice, companies also should take care not to characterize a claim in a manner that makes establishing coverage more difficult, and remember that more than one insurance policy may apply to the same loss or claim (and the order of notice may be important).

5. **How will a settlement impact insurance coverage?** Before settling a claim, policyholders should consider how a settlement may impact insurance coverage. Almost all policies require an insurer's consent before settling, but such consent may be excused in some states when an insurer denies coverage or otherwise unreasonably refuses to settle. Another common issue comes up when a lawsuit asserts both covered and uncovered claims or names both covered and uncovered parties. In those circumstances, insureds

should assess how the policy or applicable law will treat issues of allocation.

With the emergence of novel securities claims in the wake of COVID-19, a review of these issues before a claim is made will ensure that your company is well positioned to limit its exposure as it faces new securities risks.

To see our prior alerts and other material related to the pandemic, please visit the Coronavirus/ COVID-19: Facts, Insights & Resources page of our website by clicking here.

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