THE REVIEW OF
SECURITIES & COMMODITIES REGULATION
AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 54 No. 9 May 5, 2021

NOVEL SECURITIES LIABILITIES FROM THE CORONAVIRUS AND UTILIZING INSURANCE TO MANAGE THE RISK

In this article the authors address insurance protection from securities liabilities arising from the COVID-19 pandemic. They discuss seeking improvements and avoiding problems during underwriting; proactive steps when restrictive terms cannot be avoided; and best practices for securing coverage.

By H. Gregory Baker, Rachel Maimin, Andrew Reidy, and Joseph Saka *

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 claims, 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.

There also has been an uptick in enforcement activity by the Securities and Exchange Commission. 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.[1]

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 view 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

* *H. GREGORY BAKER, RACHEL MAIMIN, and ANDREW REIDY are partners in Lowenstein Sandler LLP, and JOSEPH SAKA is senior counsel at the firm. Their e-mail addresses are hbaker@lowenstein.com, rmaimin@lowenstein.com, areidy@lowenstein.com, and jsaka@lowenstein.com.*

[1] *In the Matter of The Cheesecake Factory Inc*., SEC Adm. Proc. File No. 3-20158 (December 4, 2020).

RSCR Publications LLC Published 22 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $1,197 per year in U.S., Canada, and Mexico; $1,262 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call 609-683-4450; fax 609-683-7291; write Subscriber Services, RSCR Publications, PO Box 585, Kingston NJ 08528; e-mail cri.customer.service@comcast.net; or visit our website at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@gmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail sarah.s.himmelfarb@gmail.com. To submit a manuscript for publication contact Ms. Himmelfarb.

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.

There are three main considerations that businesses and their directors and officers should be evaluating now: (1) potential improvements to existing D&O policies during underwriting; (2) proactive steps to take if restrictive terms are being added to replacement D&O policies; and (3) best practices for the securing coverage in the event claims are asserted.

SEEKING IMPROVEMENTS AND AVOIDING PROBLEMS DURING UNDERWRITING

Where possible, the best way to avoid insurance coverage disputes is to address problematic language during underwriting before a claim is made.

First, consider the scope of coverage not only for lawsuits, but also 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, a subpoena, a search warrant, or a civil investigation demand. Thus, depending on how that term 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, while subject to a sublimit, provide coverage for costs and expenses incurred in responding to regulatory investigations that have not yet developed into a lawsuit or formal claim.

Second, try to narrow or avoid problematic exclusions. For example, most policies contain dishonesty or fraudulent acts exclusions. But there are a number of steps policyholders can take to minimize the effect on coverage, including adding language so that the exclusion applies only where there has been a final adjudication in the underlying case and does not apply to innocent directors and officers. As another example, the vast majority of D&O policies contain prior acts or prior litigation exclusions that bar coverage for claims, or "related" lawsuits, that were asserted prior to the policy period. Where possible, seek a narrower and clearer exclusion, so that there is little doubt regarding what is excluded. At the same time, be mindful of hidden limitations on coverage buried in definitions and elsewhere in the policy.

Third, 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 the insurer's duties. As another illustration, although insured v. insured exclusions typically only bar coverage 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 following a bankruptcy. Many courts have rejected this position, but during the underwriting and placement of D&O insurance, directors and officers should seek endorsements expressly providing that the insured v. insured exclusion does not apply to claims by trustees, receivers, or creditors' committees.

PROACTIVE STEPS WHEN RESTRICTIVE TERMS CANNOT BE AVOIDED

Even before the pandemic, the insurance industry anticipated a hardened D&O insurance market during which policyholders would face both higher premiums and less favorable policy language. Thus, many companies unfortunately will find that restrictive terms are being added to their replacement D&O policies, including lower limits, higher deductibles, and new exclusions including, in some instances, exclusions for COVID-19 related claims.

What can be done in this situation? 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 only provide coverage 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 during the earlier policy period. In situations where insurers are adding restrictions that will limit coverage for anticipated claims, this can be hugely important.

Before providing a notice-of-circumstances letter, however, policyholders need to understand policy requirements and the potential ramifications. Many policies require detailed information regarding the potential claim including the identity of the potential claimants and defendants, a description of the damages, and the specifics regarding the wrongful acts potentially giving rise to a claim. If the required detail is not provided, some insurers may seek to avoid their coverage obligations. Moreover, once an insurer receives notice of circumstances, the insurer may attempt to add exclusions going forward to bar coverage broadly for claims arising out of the wrongful acts described in the notice of circumstances.

Thus, while this is an important protection, it should be done in consultation with insurance broker and coverage counsel.

BEST PRACTICES FOR SECURING COVERAGE FOR CLAIMS

Businesses need to consider best practices for securing coverage after identifying a potential securities issue or receiving a securities claim.

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 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 experienced brokers and insurance recovery counsel to evaluate: (1) what insurance policies and/or indemnification provisions may apply; (2) when is the organization required to provide notice; (3) how the notice requirement is 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 insurer may respond to the same loss or claim (and the order of notice may be important).

Before settling a claim, policyholders again 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 where 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.

Most importantly, businesses should carefully review denials of coverage. In most states, there are core principles that generally favor insureds. Among other things, policy language typically is interpreted in accordance with policyholders' reasonable expectations and, if there are any ambiguities in the language, they are construed in favor of coverage. Moreover, courts usually construe insurers' defense obligation broadly: depending on the policy language, if even some of the allegations in a complaint are potentially covered, the insurer may have a defense obligation for the entire lawsuit.

* * *

Businesses should anticipate that novel securities claims pertaining to COVID-19 will continue in the foreseeable future. With an aggressive plaintiffs' bar and an active SEC expected with the Biden Administration, companies need to prepare in part by considering how their existing and replacement insurance policies will help them manage these exposures. For 2021, directors and officers should review their insurance program to assure they are limiting exposure to new securities risks and maximizing the value of this important, but often overlooked, asset. ■