2018 Year In Review

News and Developments in Executive Liability and Insurance

Volume 15

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Contents

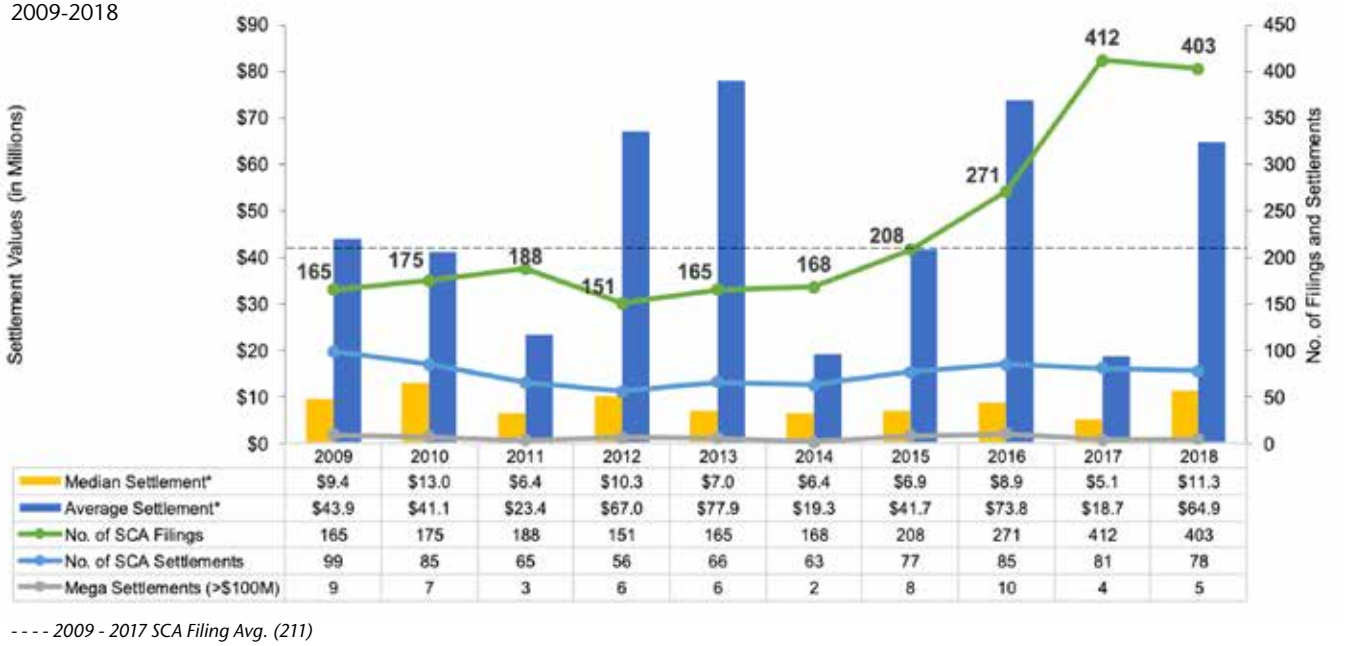
From the Editors

Aon's Financial Services Group is pleased to present our fifteenth annual Year in Review. It is again organized by subject matter, summarizing legal developments in insurance coverage cases relating to management liability, as well as cases dealing with the U.S. Securities laws, corporate governance and other issues. We also review recent trends in securities class action litigation.

The securities class action environment once again saw near-record levels of filings in federal courts, more than 200% above the average annual number of filings in the past twenty years. The chart below shows the filings since 2009 and also depicts the median and average settlement amounts for those years. It is interesting to note that since 2017, the average and median settlement amounts have more than doubled. In 2018, there were five settlements of at least $100 million.

In 2018, the United States Supreme Court issued its much-anticipated decision in *Cyan, Inc., v. Beaver County Employees Retirement Fund* (discussed herein, page 38) in which it held that state courts have concurrent jurisdiction for cases brought under the Securities Act of 1933. This gives rise to a more complicated litigation scenario for IPO-related litigation.

Securities Class Actions Filings v. Securities Class Action Settlements
2009-2018



	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Median Settlement*	$9.4	$13.0	$6.4	$10.3	$7.0	$6.4	$6.9	$8.9	$5.1	$11.3
Average Settlement*	$43.9	$41.1	$23.4	$67.0	$77.9	$19.3	$41.7	$73.8	$18.7	$64.9
No. of SCA Filings	165	175	188	151	165	168	208	271	412	403
No. of SCA Settlements	99	85	65	56	66	63	77	85	81	78
Mega Settlements (>$100M)	9	7	3	6	6	2	8	10	4	5

- - - - 2009 - 2017 SCA Filing Avg. (211)
**Settlement dollars are adjusted for inflation; 2018 dollar equivalent figures are used.*
Sources: Cornerstone Research – Securities Class Action Filings (2018 Year in Review) and Securities Class Action Settlements (2018 Review and Analysis)

A rising trend is what has been termed "event-driven" litigation, in which securities lawsuits are filed after an event negatively affects a company's stock price. Such lawsuits have been filed after a data breach, the California wildfires, or other newsworthy events. Shareholder derivative litigation is also on the rise, sometimes from these same events, or, where an event has occurred, but the stock price has not appreciably declined. Examples of this type of litigation can be found related again to a data breach, or, for example, companies facing #MeToo movement issues.

The 2018 Year in Review also addresses several insurance coverage issues that arise in the management liability arena, including those related to the definition of claim, or whether claims are related for purposes of the insurance coverage. Other cases address the definition of "professional services," capacity issues, and whether an exclusion is applicable, based on prior acts, prior knowledge, prior litigation or prior notice of a claim. We continue to see and review cases involving social engineering matters, and how a fidelity policy's computer fraud provision or the concept of direct loss affects coverage.

We hope you enjoy the 2018 Year in Review. We look forward to advising on the issues and trends of 2019. Thank you for your interest and support.

Best Regards,

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News & Developments

First Quarter

Securities Suit Filings Hit Historic Levels

In 2017, there were 415 securities class action lawsuits filed. This was the most in any year since 2001. A significant factor in the increase of litigation was due to the filing of a large number of merger objection lawsuits. There were 222 traditional securities lawsuits filed in 2017, 18% more than the number filed in 2016. There were 193 merger objection suits filed in 2017, up 140% from 2016. In addition to the number of actual lawsuits being up, the litigation rate (the percentage of public companies that are sued) increased to 9% from 5.6%. In the past few years the litigation rate has been increasing because the number of public companies has been decreasing. However, for 2017, the increase in the litigation rate was attributed to the increase in actual litigation.

The suits were generally spread across all industries with the pharmaceutical preparations category experiencing the most filings. Life sciences, high tech and banking combined accounted for approximately 34% of all securities lawsuit filings. Fifteen of the securities lawsuits were filed against companies related to their IPOs which occurred from 2014-2017.

Observing trends, it was noticed that many lawsuits filed were related to operational events that caused a setback to the company rather than the typical financial misrepresentation allegations seen in the past. Another trend that emerged is that smaller law firms were bringing the lawsuits against smaller companies. It remains to be seen whether trends continue in 2018 as the number of securities lawsuits filed decreased significantly during the second half of 2017.

SEC Halts Bank's Initial Coin Offering

The SEC obtained a court order to halt Arise Bank's efforts to target retail investors in what was claimed to be the first "decentralized bank." The Dallas-based Arise Bank sought to raise $1 billion for its cryptocurrency by allegedly misrepresenting to investors that it was a first of a kind decentralized bank offering its own cryptocurrency. The sale of AriseCoins to the public began in December of 2017 with an anticipated conclusion date in January of 2018 and a distribution to investors in February of 2018.

The company, founded by Jared Rice Sr. and Stanley Ford, had been issued a cease and desist order by the Texas Department of Banking after it was identified as unauthorized and unregulated. The SEC froze the crypto assets including Bitcoin, dogecoin and others, and appointed a receiver to return assets to investors. The action filed by the SEC against the company and its principals alleged that they falsely stated that they had purchased an FDIC-insured bank and offered customers the ability to obtain a bank-branded VISA card to spend many of its cryptocurrencies.

This appears to be the first time that the Commission sought the appointment of a receiver in connection with an Initial Coin Offering fraud and Steven Peikin, co-director of the SEC's enforcement division, indicated that they will continue to seek to halt fraudulent conduct in the digital securities arena. The court in Dallas approved the emergency asset freeze and appointed a receiver over Arise Bank and its assets. The SEC now seeks injunctions, disgorgement and interest and penalties as well as prohibitions to be imposed upon the bank's principals.

CFTC Brings Cybersecurity Enforcement Action

A registered futures commission merchant (FCM) was charged with violations of Commodity Futures Trading Commission (CFTC) regulations for failing to supervise a vendor's implementation of the FCM's system security program. The violation resulted in a CFTC enforcement action for a cybersecurity failure at a CFTC–registered entity. During the installation of a network attached storage device (NASD), the FCM's vendor created an open access route from the Internet through the FCM's firewall into the NASD resulting in unencrypted customer records being stored on the device. Despite the breach, network security risk assessments did not detect security abnormalities. This was a violation of the CFTC regulation which requires every CFTC registrant to "diligently supervise the handling of confidential information..." Contracting the service out to a vendor did not relieve the CFTC registrant of that duty. The violation resulted in a rare CFTC enforcement action based on cybersecurity failure at a CFTC registered entity. The FCM submitted an Offer of Settlement, agreeing to pay a $100,000 civil penalty and to cease and desist from any further violations of the regulations. The CFTC accepted the offer. *In the Matter of AMP Global Clearing LLC, Respondent.* CFTC Docket No.18-10.

Investor Files Derivative Lawsuit Claiming Wynn Resorts Board Turned a Blind Eye to Steve Wynn's Alleged Sexual Misconduct

Another high-profile sexual harassment situation has led to yet another investor lawsuit. A Wynn Resorts shareholder filed a derivative lawsuit in Nevada state court against billionaire casino mogul Steve Wynn and the Wynn Resorts board of directors alleging that the board and General Counsel at Wynn Resorts knew for years of Wynn's sexual misconduct but intentionally disregarded it.

Steve Wynn is credited with helping to revitalize the Las Vegas Strip in the 1990s. He built some of the most famous and successful casino hotels, including the Bellagio, Treasure Island, and the Mirage and he founded Wynn Resorts. In a January 27, 2018 article entitled "Dozens of People Recount Pattern of Sexual Misconduct by Las Vegas Mogul Steve Wynn," the Wall Street Journal reported that a number of women said Wynn sexually assaulted or harassed them and that Wynn paid $7.5 million to settle a claim by a manicurist employed by Wynn's organization, who alleged that he forced her to have sex during an appointment. The article reported that a separate company set up by Wynn and his legal representatives to handle the settlement, helped hide the payment.

In the days after the Wall Street Journal article appeared, the casino and resort company's stock fell dramatically. Additionally, the Nevada and Massachusetts gaming regulators are now investigating Wynn, and Macau officials expressed concern about reports of Wynn's "inappropriate behavior."

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A Wynn Resorts shareholder filed a derivative action two weeks after the story broke. Plaintiff sued Steve Wynn, and certain of its directors and officers, alleging Wynn himself "knowingly and intentionally breached his fiduciary duties by engaging in a pattern of intentional egregious misconduct" and that "[t]he board knowingly turned a blind eye to allegations of patently egregious misconduct by Mr. Wynn involving the company, taking no action to protect the company and its suitability for regulatory compliance and to discharge the directors' known fiduciary duties to the company to do otherwise until the WSJ report shed light to the public, and even then the board is merely conducting an internal investigation."

Wynn Resorts said that its board had formed a special committee to investigate the allegations of sexual misconduct against Wynn. Wynn has defiantly defended himself and claims that the sexual assault allegations are "preposterous" and stem from a "nasty" lawsuit between Wynn and his ex-wife. Wynn resigned his position as Chairman and CEO of Wynn Resorts less than two weeks after the Wall Street Journal report ran.

U.S. Securities Suit Settlement is Fifth Largest

Brazilian-based energy company Petrobras recently agreed to settle a securities class action lawsuit pending in the Southern District of New York for $2.95 billion. If approved, the settlement will be the fifth largest U.S. securities class action settlement of all time.

The lawsuit arose out of corruption and bribery allegations whereby certain company executives purportedly circumvented the company's bidding process via a cartel formed by several large construction companies, and in return, allegedly received kickbacks. Once the scheme was revealed to the public, the company's shares traded on the Brazilian stock exchange declined by over 80%, and its sponsored American Depository Shares (ADS) traded on the New York Stock Exchange (NYSE) declined by 78%.

The investors who had purchased the company's ADSs on the NYSE filed a securities class action lawsuit asserting claims under both the Securities Exchange Act of 1934 and the Securities Act of 1933. The complaint was amended to add claims alleging violations of Brazilian securities laws asserted on behalf of investors who had purchased the securities on the Brazilian stock exchange. The district court ruled on the defendants' motion to dismiss that the Brazilian securities law claims were subject to mandatory arbitration in Brazil pursuant to the company's bylaws. The case then moved forward – up through the United States Supreme Court - to address class certification. At the time the settlement was announced by the parties, the Court was scheduled to consider the defendants' cert petition on the question of what evidence is required in order to invoke the presumption of reliance for purposes of a motion for class certification. The settlement resolves only claims of investors who purchased the company's securities in the U.S. Additionally, the settlement does not resolve claims pending against the company's outside auditor

SEC Investigation of Theranos Serves as a Warning to Private Companies

As noted in this Quarterly Review of noteworthy SEC enforcement actions, the SEC recently announced that it settled charges of fraud against a private company, Theranos Inc., and its founder and CEO, Elizabeth Holmes. The SEC's allegations related to Holmes' and former President Ramesh Balwani's "years-long fraud in which they exaggerated or made false statements about the company's technology, business and financial performance." The false statements were primarily made with respect to Theranos' key product, a portable blood analyzer that purportedly could conduct comprehensive tests with just a drop of blood. Not only did Holmes and Theranos allegedly hoodwink their investors, who provided $700 million in funding through a series of private offerings, but the essentially fake blood tests they performed created significant heartache for patients who later learned their test results were inaccurate. Holmes ultimately agreed to pay a $500,000 penalty to resolve the charges. She is also barred from serving as a public company director or officer for 10 years, must return 18.9 million shares obtained during the fraud, and is required to relinquish voting control. Litigation is ongoing against Balwani.

The SEC charges and settlement have been widely discussed within the insurance, legal, and investing communities. One particularly important takeaway from all the chatter is the relevance of the SEC's allegations to the risk assessment for private companies. At the most basic level, private companies are not insulated from securities claims or SEC scrutiny or investigation. Accordingly, securities-related liability needs to be considered for private company D&O placements.

Are the Tides Turning? Department of Justice Pursues Private Equity Sponsor in Alleged Payment of Kickbacks

In what may indicate a new wave of investigations and prosecutions, the United States Department of Justice ("DOJ") commenced an action under the False Claims Act against, in part, a private equity firm along with one of its portfolio companies.

The DOJ intervened in a False Claims Act case against Diabetic Care RX, LLC d/b/a Patient Care America (PCA), its private equity sponsor, Riordan, Lewis & Harden, Inc. (RLH), and two of PCA's executives. PCA was first sued by two former PCA employees who alleged that PCA paid illegal kickbacks to induce prescriptions for compounded drugs reimbursed by TRICARE (a federal health care program that provides health care insurance for active duty military personnel, military retirees, and military dependents). The DOJ intervened, alleging that the defendants engaged in a fraudulent scheme to realize short-term revenue. It is alleged that PCA retained three "marketers" to target military members and their families for prescriptions for compounded pain creams, scar creams, and vitamins, regardless of need. While these products were supposed to be compounded specifically for individual patients' needs, the formulations were in reality manipulated by the defendants and marketers to ensure the

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highest possible reimbursement from TRICARE. It is alleged, for example, that the marketers paid telemedicine doctors who prescribed the creams and vitamins but never physically examined the patients. Further, it is alleged that PCA knowingly submitted claims to TRICARE for reimbursement for compounded drugs that were false or fraudulent because they were tainted by kickbacks to marketers and patients, and did not arise from a valid prescriber-patient relationship. The defendants also allegedly conspired to cover the copayments of a number of patients in order to induce the patients to accept the compounded drugs.

With respect to the private equity company, the complaint alleges that RLH directed PCA's involvement into topical compounding because of its extraordinary profits. Further, it is alleged that RLH made a controlling investment in PCA and that two of the partners from RLH became officers of PCA. The allegations suggest that the two private equity firm partners guided the strategic direction of PCA and "knew and approved of" the marketing arrangements at the heart of the complaint. Moreover, the complaint states that, as an investor in other health care companies, RLH "knew or should have known ... that health care providers that bill federal health care programs are subject to laws and regulations designed to prevent fraud, including the federal anti-kickback statute."

Given the DOJ's prosecution of not only the company directly involved in the kickback scheme, but also the private equity sponsor, it will be interesting to see whether the DOJ engages in similar types of prosecutions, seeking to hold private equity sponsors accountable for their portfolio companies – at least within the healthcare industry.

Second Quarter

Justice Anthony Kennedy Announces Retirement from the Supreme Court

United States Supreme Court Justice Anthony Kennedy announced that he will retire from the Supreme Court on July 31, 2018. Justice Kennedy, who turns eighty-two in July, has been on the bench since 1988. He is the longest-serving justice currently on the Court. Justice Kennedy, a centrist, has been considered the swing vote in some of the Court's biggest and most controversial cases. He graduated cum laude from Harvard Law School and was a prominent Sacramento, California attorney and Professor of Constitutional Law when he was appointed to the Court of Appeals for the Ninth Circuit in 1975. At thirty-eight, he was the country's youngest federal appeals court judge. His record on the federal bench was a conservative one but he approached each case on an individual basis. President Ronald Reagan nominated Justice Kennedy to the Supreme Court and, after being confirmed by the United States Senate by a unanimous vote, took his seat on February 18, 1988.

Early in his tenure, Justice Kennedy was very conservative and voted with two of the Court's most conservative judges more than ninety percent of the time. In subsequent years, his decisions displayed thoughtful independence that did not reflect any particular ideology. His episodic departure from conservative jurisprudence reflected a civil libertarian perspective on certain individual rights. Justice Kennedy voted with the Court's liberals to declare unconstitutional, a Texas law that prohibited the desecration of the American flag on the grounds that the Constitution protects such acts as symbolic speech. He also wrote the Court's opinion that voided an amendment to the Colorado state constitution that prohibited state and local governments from enacting laws that would protect rights of gays, lesbians and bisexuals. Justice Kennedy voted in favor of upholding a key component of the 2010 Affordable Care Act allowing the federal government to provide nationwide tax subsidies to help Americans buy health insurance. On June 26, 2015, the Supreme Court announced the landmark five to four ruling guaranteeing the right of gay couples to marry throughout the United States. Justice Kennedy wrote the majority opinion in which he stated, "[t]he Court now holds that same-sex couples may exercise the fundamental right to marry. No longer may this liberty be denied to them." Justice Kennedy's ability to reach conclusions based upon his understanding of the law without bias or partisanship is characteristic of his dedicated service to the Supreme Court. He will retire after thirty years of distinguished service.

U.S. Supreme Court Grants *Cert* on Question of Who Must "Make" a Fraudulent Statement

The United States Supreme Court accepted certiorari on a case that presents the question of who must "make" a fraudulent statement in order for liability to attach for securities law violations. The legal question for the Supreme Court is whether an individual can be liable for fraudulent disclosures if the individual did not make such fraudulent disclosure. There is a split of authority among the Circuits. In particular, the Court will evaluate whether a misrepresentation alone – a misrepresentation for which an individual cannot be held liable on a fraudulent statement theory – is sufficient to establish liability on a scheme liability theory, even if the individual did not "make" the misrepresentation.

In the underlying case, an individual worked as the director of investment banking at a broker-dealer and, in that capacity, acted as the placement agent for private offerings. One such offering was on behalf of a publicly-traded energy company client. The client had publicly disclosed a significant decline in its asset value; however, the director did not send that information to two prospective private placement investors when they made a request for investment. The director highlighted the positive attributes of the client in soliciting investments but did not provide the client's recent disclosure regarding the significant decline in asset value.

Continues

The Securities and Exchange Commission commenced enforcement proceedings against that director and others in connection with the private placement offering. While other defendants settled with the SEC, the director elected to proceed to trial before an administrative law judge, which found him liable under the federal securities laws for participating in a scheme to deceive, manipulate, or defraud potential investors. On appeal the court held that the director could not be held liable for a fraudulent misrepresentation under Rule 10b-5(b) because he did not "make" the statements at issue. Interestingly, the court determined that the administrative law judge's ruling should be upheld because he did provide false and misleading information to potential investors with the intent to deceive.

The Supreme Court previously ruled, in the Janus Funds case, that only a "maker" of a misrepresentation can be held liable in a private securities lawsuit. In this case the court concluded that while the director did not "make" the misrepresentation at issue he could be held liable for the misrepresentation under the federal securities laws, on a scheme liability theory.

This case will provide an opportunity for the Supreme Court to clarify the requirements of scheme liability under the federal securities laws.

The Pros and Cons of Barring IPO-Related Securities Class Actions

There has been much discussion in recent months about whether the United States Securities and Exchange Commission ("SEC") might bar IPO related litigation in favor of arbitration. Proponents of arbitration argue that it would eliminate frivolous lawsuits and "reduce costs of securities litigation for issuers in a way that protects investors' rights and interests." Proponents further argue that this change would incentivize more companies to go public in the U.S. markets, and, that the burden and expense of securities class actions are likely a factor in the decline of IPOs in recent years. Other reasons that pre-IPO companies remain private may be increased equity investments and revenue growth from a strong economy.

According to a paper published by ISS, Securities Class Action Services, those who oppose mandatory arbitration are concerned that, while more companies may offer IPOs, it will adversely affect the rights of investors to recoup their losses when fraudulent activities occur. The costs of bringing claims individually in arbitration may exceed the amount of recovery for individual investors so that individual investors will lack the economic incentive to bring an individual case. Other unintended effects could be to place the burden of investigating and litigating these cases entirely on the SEC and diminishing the deterrent effect of wrongdoing in this sector. The dangers of restricting shareholders' rights to sue in a class action could outweigh any potential benefits.

In the last ten years, IPO class action litigation accounts for four percent of all securities class actions, however that number has been increasing steadily and has climbed to approximately 6.8 percent in 2017. A disproportionate number of IPO suits are filed against smaller companies. Only two suits have been tracked against large capital, S&P 500 companies over the last ten years. A fair amount of litigation has named high-priced tech company IPOs as defendants. Class action litigation was filed against five of the top six high-priced tech companies that went public in the last decade. Settlements and disbursements are also smaller than for other securities class actions. IPO disbursements make up just two percent of the total payments for securities class actions in the last ten years.

Arguably, even though IPO class actions represent a small percentage of litigation and settlements in the securities class action arena, IPO shareholders should have the means to exercise their rights to redress alleged fraudulent conduct in a public setting that will have the added benefit of deterring fraudulent conduct in the future.

Third Quarter

Securities Class Actions Rise to Near Record Levels for the First Half of 2018

According to Cornerstone Research's report, "Securities Class Action Filings 2018 Midyear Assessment," more than 750 securities class actions have been filed in the last 24 months, making it the "most prolific" period since the Private Securities Litigation Reform Act of 1995 ("PSLRA") went into effect. While filings against non-US companies may have decreased in the first half of 2018, overall, in the last 20 years, core (those excluding merger and acquisition claims) filings have trended upward. The increase appears to be driven mainly by core filings against communications/internet companies. Those sectors saw triple the number from the last half of 2017.

The Second and Ninth Circuit Courts of Appeal were the dominant venue for class action filings; the Second and Eleventh Circuits saw decreased core filings. The Ninth Circuit, on the other hand, saw triple the number of filings from the second half of 2017. Merger & Acquisition ("M&A") filings continue to be the most common in the Third and Ninth Circuits, accounting for 48% of all class actions filed during the first half of 2018. Cryptocurrency, or Initial Coin Offering ("ICO"), filings continue, and two of the twelve actions filed had a parallel action filed in state court.

In addition to upward trending federal filings, Cornerstone noted an increase in state court filings, due primarily to the United States Supreme Court's March 2018 decision in Cyan v. Beaver County Employees Retirement Fund. That decision allowed plaintiffs to assert 1933 Securities Act claims in state court. The report commented that state action filings are expected to rise further.

Continues

Some additional key trends that were pointed out by the Cornerstone report include the following:

- So-called "mega filings" with a disclosure dollar loss of at least $5 billion rose from 4% of total filings to over 12%.
- Almost 10% of all S&P companies were defendants in a core securities claim in the first half of 2018.
- On average from 2001-2017, one in nineteen (over 5%) of S&P companies were the subject of a securities claim.

The health care sector, followed by the communication sector, were the most common target sectors of a securities claim in the S&P 500. Biotechnology and healthcare were the most common subsectors.

Another Investor Class Action Filed in Response to Revelations of Sexual Misconduct

A shareholder of a pizza restaurant chain filed a securities class action lawsuit against the company, its founder and former CEO and Chairman, and two other executives, alleging that the defendants turned a blind eye to the founder's and executives' pattern of sexual harassment and other inappropriate workplace conduct and failed to disclose the problem.

After news broke that the founder had used a racial slur during a conference call in May 2018, the company's stock price fell almost 5%. Later that day, the company announced that the founder resigned as chairman of the board. About a week later, Forbes published an article citing interviews with 37 current and former employees—including numerous executives and board members — reporting that the founder's "alleged behavior ranges from spying on his workers to sexually inappropriate conduct, which has resulted in at least two confidential settlements." Forbes cited multiple sources saying meetings were filled with profanity and inappropriate comments and that the CEO never intervened. The article further reported that "[t]o protect himself, [the founder] . . . installed loyalists in the firm's top ranks, who enabled its 'bro' culture." On this news, the company's stock price fell 4.85%.

In response to this news, a shareholder filed a complaint alleging that (i) the company's executives, including the founder, had engaged in a pattern of sexual harassment and other inappropriate workplace conduct at the company; (ii) the company's Code of Ethics and Business Conduct was inadequate to prevent the foregoing misconduct; and (iii) the foregoing conduct would foreseeably have a negative impact on the company's business and operation, and expose the company to reputational harm, heightened regulatory scrutiny, and legal liability; and (iv) as a result, the company's public statements were materially false and misleading at all relevant times. The complaint refers to, and quotes, the Forbes article.

Danker v. Papa John's Int'l, Inc., No. 18-cv-07927 (S.D.N.Y. 2018).

SEC Settles Suit against Elon Musk and Tesla over his Tweet

In a nine-word message posted on Twitter on August 7th, 2018, Musk pronounced, "Am considering taking Tesla private at $420. Funding secured." Four hundred twenty dollars per share would have represented a substantial premium to its trading price at the time. After his tweet, Tesla's stock price went up more than 6% on significantly increased volume and led to significant market disruption. The SEC investigated and on September 27, 2018, filed a lawsuit against Musk alleging securities fraud. The SEC alleged that: Musk knew that the potential transaction was uncertain and subject to numerous contingencies; Musk had not discussed specific deal terms, including price, with any potential financing partners; and his statements about the possible transaction lacked an adequate basis in fact. The SEC sought to bar Musk from serving in any type of officer role at a publicly-traded company. The SEC also brought charges against Tesla, claiming that it had no disclosure controls or procedures in place to determine whether Musk's tweets contained information required to be disclosed in Tesla's SEC filings. Nor did Tesla have sufficient processes in place so that Musk's tweets were accurate or complete. A few days later, Musk and Tesla settled with the SEC without admitting or denying any wrongdoing. As part of the deal, Musk must step down as Tesla's Chairman, Musk will be ineligible to be re-elected Chairman for three years, Tesla will put in place additional controls and procedures to oversee Musk's communications, and Musk and Tesla will each pay a separate $20 million penalty. The $40 million in penalties will be distributed to harmed investors under a court-approved process. Per the terms of the settlement, Musk must pay $20 million of the penalty personally, without using insurance or other indemnification. He will remain Tesla's CEO.

The Co-Director of the SEC's Enforcement Division said, "The resolution is intended to prevent further market disruption and harm to Tesla's shareholders." After the settlement, a US District Court judge in New York requested that the parties explain why she should approve the settlement. Musk then tweeted, "Just want to [sic] that the Shortseller Enrichment Commission is doing incredible work. And the name change is so on point!" Tesla's stock dropped more than 6%.

Fourth Quarter

Event-Driven Litigation: A Trend to Watch

Recently, certain adverse events, such as the Marriott cyber breach, the Lion Air plane crash and the deadly California wildfires, have been followed by directors and officers (D&O) insurance claims in the form of securities class action lawsuits and derivative litigation. Although the underlying events themselves are vastly different, the common nexus is that the events are disruptive, have significant business impact, and extremely large adverse potential damages or consequences.

Instead of alleging typical accounting irregularities, event-driven litigation focuses on a significant adverse event and what the company and the board knew and whether they allegedly failed to inform or warn investors. New plaintiffs' firms are jockeying for position in this new event-driven securities litigation space. Event-driven lawsuits are often pled under the Securities Exchange Act of 1934 in response to a drop in the company's share price, although derivative litigation is also filed. The allegations are generally that the defendants materially misled the investing public with glowing reports that inflated the stock price, and that defendants failed to disclose material information regarding the risks at issue.

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For example, investors brought two such lawsuits in the wake of the Chegg and Marriott data breaches. First, certain shareholders quickly filed a securities class action against Chegg (a provider of educational materials and services to high school and college students), alleging federal securities law violations, after learning through Chegg's Form 8K of a prior data breach. The plaintiffs alleged misrepresentations or failures to disclose material information regarding the apparent lack of security measures to protect users' data along with the apparent lack of internal controls to detect such unauthorized access.

Similar allegations were made against Marriott and its board. One day after the news of the massive data breach, a securities class action lawsuit was filed against Marriott.

Likewise, the recent California wildfires were widely known for the devastating and destructive loss of life and property in Northern California. Shareholders in the utility company filed a wildfire-related securities class action regarding its role in the devastation. A shareholder also filed a derivative lawsuit against the board and officers of the utility company regarding the board's role, and alleged misleading information regarding the utility's readiness and exposure.

Another recent event that sparked D&O litigation is the Lion Air fatal plane crash into the Java Sea. As soon as details came to light regarding the possible role of a new Boeing jet's flight control features, Boeing shareholders filed a securities suit alleging misrepresentations and omissions about the features.

Whether the lawsuits filed can be sustained and survive motions to dismiss will be determined by the courts. In one such recent lawsuit, the court did grant defendant PayPal's motion to dismiss on the ground that plaintiffs failed to show that PayPal's customers' awareness of its data breach had caused the stock drop. We will continue to monitor these cases and important developments.

Securities Class Action Filed Based on Stock Drop after Revelation of Alleged Consensual Office Romance

As an example of the event driven securities litigation discussed above, a shareholder of a telehealth services company ("Company") filed a federal securities class action to pursue remedies under Sections 10(b) and 20(a) of the Securities and Exchange Act of 1934. The matter arose after an online financial investigative reporting website published an article reporting the 54-year-old, married, male chief financial officer (CFO) at the Company had had an affair with a subordinate female employee in her late 20s (Subordinate), and that the two engaged in potentially-illegal insider trading.

The article reported that the Subordinate would tell her coworkers about the affair and that after she received a stock grant, the CFO would tell her when he thought there were good opportunities to sell some shares. She proudly told colleagues that his track record "was pretty good." Some employees reportedly complained to a female executive at the Company about the affair and purported insider trading and that executive reported the matter the Company's human resources department. The Company retained an outside law firm to investigate the allegations, which were ultimately shown to be true. Nevertheless, the Company's discipline of the CFO was to enter into an amended employment contract with him containing: a prohibition from violating the employee handbook, and for a period of one year, a suspension of the scheduled share vesting awarded to him as compensation. The Company fired the female executive who reported the matter to the Company's HR department, and the Subordinate "resigned quietly." The article further alleged that for years, the Company had allowed employment discrimination, sexual harassment, and violation of its own corporate governance policies.

After the article's publication, the company's stock price fell by 6.69% and the plaintiff filed an action against the Company and certain of its executives, alleging that defendants made materially false and misleading statements regarding the Company's business, operational and compliance policies. The plaintiff alleges that defendants made false and/or misleading statements and/or failed to disclose that:

(i) the CFO was engaged in an inappropriate sexual relationship with a subordinate;

(ii) the CFO and the Subordinate engaged in insider trading to provide themselves with undue benefits;

(iii) the CFO caused the Subordinate to receive promotions for which she was unqualified, thereby negatively impacting the Company's operations;

(iv) the Company's enforcement of its own purported employment and trading policies were inadequate to prevent the foregoing conduct; and

(v) as a result, the Company's public statements were materially false and misleading.

The plaintiff alleges that the stock dropped "sharply" after the alleged affair became public. Whether this lawsuit survives motion practice remains to be seen.

New York Attorney General Sues Exxon Mobil for Allegedly Defrauding Investors Regarding Climate Change Regulation Risks

In a ninety-three-page complaint, the New York Attorney General filed suit against Exxon Mobil that "seeks redress for a longstanding fraudulent scheme by Exxon, one of the world's largest oil and gas companies, to deceive investors and the investment community including equity research analysts and underwriters of debt securities... concerning the company's management of the risks posed to its business by climate change regulation." The complaint notes that New York individual and institutional investors hold significant investments in Exxon.

The complaint alleges that "[i]nstead of managing those risks in the manner it represented to investors, Exxon employed internal practices that were inconsistent with-its representations, were undisclosed to investors, and exposed the company to greater risk from climate change regulation than investors were led to believe." The complaint further describes instances in which Exxon claimed it had accounted for governmental climate change regulation risk by applying a "proxy cost" of carbon and other greenhouse gases (GHG's) to its business. A proxy cost is a cost that is included in economic projects as a stand-in

Continues

for the likely effects of expected future events. Exxon allegedly "touted in its annual Outlook for Energy report and in other company publications that it applies the proxy costs of GHG emission in its long-term projections for purposes of business planning, investment decision-making and financial reporting." The complaint, however, alleges that Exxon's proxy costs were materially false and misleading because it did not apply the proxy cost it represented to investors. The Attorney General alleges that "Exxon's financial vulnerability to climate change regulation is significantly greater than it led investors to believe" and that use of the actual proxy costs would result in "massive" costs and "substantial write downs," so Exxon used an undisclosed "alternative methodology" that allowed it to report lower costs and avoid "write downs."

The complaint further alleges that the fraud was "sanctioned at the highest levels of the company to include former Chairman and Former Chief Executive Officer Rex Tillerson, who also served as Secretary of State in the Trump Administration." Exxon allegedly made the various misrepresentations knowing its shareholders were concerned about the company's management of future climate change regulation risks.

The multi-count complaint raises both state and common-law fraud allegations, including a fraud allegation under New York's Martin Act, and seeks to enjoin Exxon from continuing to misrepresent its practices with respect to climate change regulation risk; damages, including pre-judgment interest; disgorgement of all monies obtained in connection with the fraud; restitution of all funds obtained from investors in connection with the fraud and deceptive acts; and a comprehensive review of Exxon's failure to apply proxy costs consistent with its representation, and the economic and financial consequences of that failure.

SEC Targets Cryptocurrency Company's Initial Coin Offering

The United States Securities and Exchange Commission ("SEC") recently filed a complaint against a cryptocurrency company and its founder alleging that the defendants fraudulently promoted the company's initial coin offering ("ICO") as "registered" and "approved" by the SEC and other regulators. Despite relying upon the Form D filed with the SEC as the exemption basis to the registration requirements of the Securities Act of 1933 ("Securities Act") (requiring that any offer or sale of security must either be registered with the SEC or meet an exemption), the company's website fraudulently invoked Securities Act "Regulation A" as the basis for the exception – rather than Form D. The SEC further alleged that the defendants improperly utilized the SEC's logo to promote the ICO. The SEC claimed that the defendants allegedly created a fictitious regulatory agency known as the Blockchain Exchange Commission, or the BEC. The company's founder allegedly deceived investors by falsely conjuring similarities between the false BEC and the SEC – including similar logos, mission statements, and office addresses.

In connection with these alleged deceptions, the SEC asserted violations of Section 10(b) of the Securities Exchange Act of 1934 and numerous other sections of the Securities Act. The SEC concurrently sought, and obtained, an order granting a temporary restraining order. In granting the temporary restraining order, the court found that the SEC demonstrated a prima facie case of violations of the Securities Act and a reasonable likelihood that the wrong would be repeated. As a result, the court issued an order freezing defendants' assets, prohibiting the destruction of documents, granting expedited discovery, and requiring an accounting.

SEC v. Blockvest LLC, 2018 U.S. Dist. LEXIS 179424 (S.D.Cal. 2018).

SEC Files First Cease-and-Desist Proceedings against Unregistered Digital Currency Exchange

The Securities and Exchange Commission (SEC) filed a cease and desist order against, and settled with, the sole owner and operator of an unregistered online "token" trading platform (website), marking the first time the commission went after such a cryptocurrency platform based on findings that it operated as an unregistered securities exchange.

The website, launched in July 2016, is an online platform that provides a user-friendly interface that allows buyers and sellers to trade certain digital assets in secondary market trading and resembles online securities trading platforms. The website provided access to a proprietary cryptocurrency order book, and displayed bids and offers by symbol, price, and size. The website provided the means for these orders to interact and execute through the combined use of the website, order book, and pre-programmed trading protocols. The SEC found the digital tokens to be securities because purchasers "invested money with a reasonable expectation of profits, including through the increased value of their investments in secondary trading, based on the managerial efforts of others."

Section 5 of the Exchange Act makes it unlawful for any broker, dealer, or exchange, directly or indirectly, to affect any transaction in a security, or to report any such transaction, in interstate commerce, unless the exchange is registered as a national securities exchange, or is exempted from registration. Section 3(a)(1) of the Exchange Act defines an "exchange" as:

> any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange.

The SEC found that the website met the criteria of an "exchange" and that the website had not registered with the SEC as a national securities exchange, nor did it operate pursuant to any registration exemption. As a result, the SEC found that the website's owner should have known that his actions would contribute to the website's violations and thus, caused the website to violate Section 5 of the Exchange Act.

The website's founder agreed to pay $313,000 in disgorgement and interest, plus a $75,000 civil fine, to settle SEC allegations.

In the Matter of Zachary Coburn, SEC File No. 3-18888, Nov. 2018.

Cases of Interest

Part 1: Coverage

Capacity

D&O Coverage Available for Executive Sued in Insured Capacity, But Not for Insured Entity

The U.S. District Court of Hawaii made a split ruling on a case seeking coverage for an insured entity and its insured executive. The court ruled that the executive was entitled to coverage because he was sued in his insured capacity, but the entity was not, because the policy did not provide coverage for the type of allegations made against the entity.

The entity, as part of a joint venture, developed a residential project in Hawaii. It assigned an executive to sit on the board of the development. Subsequently, purchasers of the development sued the companies participating in the joint venture as well as the insured executive, alleging he made numerous material and specific misrepresentations to purchasers. The entity submitted the claims to its Directors & Officers Liability ("D&O") insurer, ultimately resulting in coverage litigation.

On summary judgment, the insurer maintained that neither the entity nor the insured executive were entitled to coverage under the policy. With respect to the entity, the insurer maintained that there was no coverage because the policy only provided coverage for securities claims. Therefore, because the claims alleged against the entity did not involve the purchase and sale of securities, there was no coverage for the entity under the policy. The insurer also maintained that the insured executive was not acting in his capacity as an insured while working on the joint venture, and, as such, there was no coverage due to the outside service exclusion. This exclusion prohibited coverage for loss arising from or in any way related to an insured person serving as a director, officer, trustee, regent, governor, volunteer employee or similar position of any entity other than the insured organization. The court held that the outside service exclusion did not apply because the entity owned 51% of the joint venture, thus qualifying the joint venture as a subsidiary by policy definition. The exclusion was also inapplicable because the claims against the insured executive were broad, relating to both his activities as a director on the project and also his activities as an officer of the entity. Thus, the court found in favor of the insurer with respect to entity coverage and in favor of the insured executive with respect to individual coverage.

Maui Land & Pineapple Co. v. Liberty Underwriters Inc., 2018 U.S. Dist. LEXIS 56949 (D. Hawaii 2018).

Claim

Florida District Court Rules Coverage Does Not Date Back to Unsealed Affidavit

In an insurance dispute, a maritime company sought reimbursement of defense costs incurred in connection with the defense of a criminal investigation of its employee. Although the policy afforded coverage for criminal investigations, the policy defined a claim to require that an individual insured be identified in writing as a target of such investigation.

The dispute centered on a 2008 search warrant executed by the Department of Justice at one of the insured's subsidiaries. Documents were sought from four, including a vice president who also was issued a subpoena for documents. The insured submitted the subpoena to its insurer in connection with a request for insurance coverage for the criminal investigation. In response, the insurer advised that the matter was not yet a "Claim" because the individual was not identified as a target of the investigation. However, the insured had not been advised that the Department of Justice had submitted an affidavit, under seal, outlining the facts supporting its assertion that the individual was the subject of a criminal investigation. The affidavit was not unsealed until 2015, seven years after the insured submitted notice of the Department of Justice matter. Meanwhile, the insured arbitrated the definition of Claim, which resulted in a finding against the insured in early 2013. The insured unsuccessfully asserted that the subpoena was a Claim for which defense costs should be paid by the insurer.

The DOJ investigation continued and, in early 2013, the government offered a plea deal to the individual. The plea deal contained the first written evidence that the individual was the target of a criminal investigation. Therefore, from February 2013 through the conclusion of the criminal investigation, the insured received defense costs coverage from the policy. The insured sought full coverage, dating back to the original 2008 submission, as the individual had been a target of the criminal investigation from the outset. In support of its demand for insurance recovery, the insured submitted the unsealed affidavit. In ruling that the coverage could not extend back to 2008, the court noted the Catch-22 nature of the insured's position. The insured had to overcome the arbitration decision that the criminal investigation did not yet constitute a Claim while at the same time showing that an affidavit issued in 2008 demonstrated that an individual insured was the target of a criminal investigation. If the insured had not initiated arbitration in 2012, there would not be a binding ruling that a Claim had not yet been made. With that binding arbitration finding, the earlier-issued affidavit could not be used at the time it was unsealed to demonstrate that a Claim had, in fact, been made in 2008. The defense costs incurred between 2008 and 2013 were in excess of $2.5 million, yet the insurer was not responsible for any portion of that amount.

Crowley Mar. Corp. v. Nat'l Union Fire Ins. Co., 2018 U.S. Dist. LEXIS 20787 (M.D. Fla. 2018).

Subpoena and Tolling Agreement Trigger D&O Policy

This coverage dispute centered on whether a subpoena issued to the insured and a subsequent tolling agreement triggered the insuring agreement of a Directors & Officers ("D&O") Liability policy. The Department of Justice ("DOJ") issued a subpoena to the insured demanding certain documents relating to the DOJ's industry-wide investigation for federal health care offenses. The subpoena commanded the insured to appear before government officials and to produce documents about the insured's payments to certain charitable organizations. The subpoena advised the insured that failure to comply exposed the insured to liability in judicial enforcement proceedings.

After the insured provided notice of the subpoena to its D&O insurer, the insurer denied coverage on the basis that the subpoena did not fall within the policy's insuring agreement. The insuring agreement provided that "(t)he Insurer shall pay on behalf of the Company the Loss arising from a Claim first made during the Policy Period ... against the Company for a Wrongful Act." Claim was defined as a "written demand for monetary, non-monetary or injunctive relief made against an Insured."

Coverage litigation ensued and the court found for the insured, holding that the subpoena was a Claim for a "Wrongful Act." First, the court found that the subpoena satisfied the definition of a "Claim" because it was a written demand for non-monetary relief. Specifically, it was a written demand for the insured to appear before government officials and to produce specific documents. The insurer argued that a "demand for relief" did not include the production of documents in response to a subpoena. The court disagreed, reasoning that the subpoena demanded information, as opposed to merely requested information. The court relied upon the allegations that the DOJ had determined that the insured violated federal health care laws, and found that it was reasonable to infer that enforcement proceedings would swiftly follow any non-compliance by the insured in response to the subpoena. Further, the court concluded that the subpoena demanded a form of non-monetary relief since parties may be compelled to give testimony or to produce documents as demanded in the subpoena.

The court next found that the subpoena described a "Wrongful Act." The insurer argued that the subpoena did not state or allege that plaintiffs made improper charitable contributions or that the plaintiffs committed any other wrongdoing. According to the court however, the policy only required that a "Claim" be made "for" a "Wrongful Act," and it was not necessary for the subpoena to include language that asserted that plaintiffs engaged in an actual or alleged wrongful act. The court then held that the allegations that the DOJ had issued the subpoena because it alleged that the insured engaged in federal health care violations provided a basis to conclude that the subpoena was issued "for" a "Wrongful Act," even if the subpoena itself did not contain the allegation.

Finally, the court found that a tolling agreement entered between the insured and the DOJ qualified under the subpart of the definition of "Claim" for a "written request to toll or waive the applicable statute of limitations relating to a potential Claim against an Insured for a Wrongful Act." The insurer argued that the tolling agreement was not a Claim because it did not reference a Wrongful Act. Instead, the tolling agreement stated that the DOJ was investigating the "possible violation" of various criminal statutes and that no decision on that investigation had been made. The court found the insurer's position to be unpersuasive because the policy's definition of a Wrongful Act included an "alleged...act" and the insurer had not established that a "possible violation" did not fit within that definition. In addition, the insured alleged that the government told the insured that it believed the payment to the charitable organizations violated federal law.

Astellas US Holding, Inc. v. Starr Indem. & Liab. Co., 2018 U.S. Dist. LEXIS 89725 (N.D. Ill. 2018).

Demand Letter for Stockholder Dispute Legal Expenses is a Claim

The U.S. District Court for the District of Rhode Island ruled that a stockholder demand letter constituted a covered claim for a wrongful act under a Directors and Officers (D&O) insurance policy.

After bankruptcy reorganization, the insured had two classes of stockholders: holders of common stock ("Stockholders") and holders of Contingent Value Rights ("CVRs"). The CVRs would receive consideration if the insured engaged in a fundamental transaction *e.g.,* a sale by date certain, otherwise the CVRs would receive nothing. In June 2014, the insured announced a potential buy back of the CVRs. In reply, the Stockholders sent a letter claiming the insured owed a duty to them to delay making a fundamental transaction until after expiration of the CVRs' rights to payment and threatened legal action. The insured notified its insurer of the Stockholders' letter and it was accepted as a notice of circumstance.

The insured filed a declaratory judgment action in Bankruptcy Court against the Stockholders, clarified its obligations to the CVRs and proceeded with the tender offer. The Stockholders appealed the Bankruptcy Court decision and filed a derivative lawsuit against the insured's board of directors. Also, the Stockholders sent a demand letter to the insured claiming breach of fiduciary duties, requesting reimbursement of the Stockholders' legal fees, and demanding the policy limit for the CVR share tender price. The insured settled the dispute with the Stockholders and CVRs via a seven-figure cash payment for the Stockholders' legal fees in exchange for releases and stipulations of dismissal for all lawsuits and potential claims. The insurer denied coverage for the settlement payment and asserted there was no claim for a wrongful act because the payment to the Stockholders was to settle a dispute between the CVRs and the Stockholders, not between the insured and the Stockholders.

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The insured filed a lawsuit against the insurer for reimbursement of the settlement payment. On motion for summary judgment, the court stated that it needs to find that the insured notified the insurer of "a written demand for monetary or non-monetary relief" against the insured for "any breach of duty, neglect, error, misstatement, misleading statement, omission or act by a Company." The court ruled that the demand letter is the final iteration of the claim that the insured flagged in the notice of circumstance; i.e., the Stockholders demanded reimbursement of expenses paid fighting the insured's support for and interest in paying the CVRs, which the Stockholders deemed to be a breach of the insured's fiduciary duty to them and demanded that the insured limit its valuation of the CVRs. The insured was very much involved in and had a stake in the dispute over the CVR payments.

By virtue of the demand letter, it was clear that "Stockholders did not abandon their position that the insured should not be using company monies to pay CVRs that would expire in twenty months, but made a demand for monetary relief to settle the CVR issue." Accordingly, the court ruled that the demand letter was a claim for a wrongful act related to the alleged breach of fiduciary duty as set forth in the notice of circumstance and therefore, the payment was covered loss under the D&O policy.

Twin River Worldwide Holdings, Inc. v. Nat'l Union Fire Ins. Co., 2018 U.S. Dist. LEXIS 128431 (D.R.I. 2018).

Claim First Made

Louisiana Court Finds in Favor of Insured on Claims-Made Date

The Louisiana Court of Appeals found in favor of an insured with respect to a denial based on the claims-made date. The underlying case involved allegations against the insured hospital for negligent credentialing in the context of a medical malpractice claim. At issue in the underlying case was whether the claim sounded in general negligence or was for medical malpractice, which, in Louisiana, was required to be pursued under its Medical Malpractice Act. This issue ultimately had a bearing on both liability and insurance coverage.

The initial lawsuit was noticed by the insured to its medical malpractice insurer for the 2010-2011 policy period. At that time, it was not noticed to the Directors & Officers Liability ("D&O") policy because it was perceived to be a medical malpractice claim. However, in 2015, the court in the underlying case found that the negligent credentialing claim sounded in negligence and was outside the scope of the Louisiana Medical Malpractice Act. In light of that finding, the insured noticed the D&O insurer for the 2014-2015 policy period. The insurer disclaimed coverage asserting that the claim was made prior to the inception date of the policy. Because Louisiana is a direct action state, the D&O insurer was made part of the lawsuit, but was dismissed on summary judgment based on its coverage position.

The court of appeals disagreed with the trial court. With respect to the claims-made date, it found that "it was unreasonable to assert that [the insured] should have known that the negligent credentialing claim was being made under general negligence as opposed to a medical malpractice claim as the claim was considered covered under the auspices of the [Medical Malpractice Act]." Accordingly, it determined that the claim potentially covered by the policy (e.g. the negligent credentialing claim sounding in general negligence as opposed to medical malpractice) was first made during the D&O insurers' 2014-2015 policy period and properly noticed. In coming to its conclusion, the court stated that it would have been a "vain and useless act" for the insured to have noticed the D&O insurance during the 2010-2011 policy period because it did not cover claims for medical malpractice, which prior to the trial court's ruling, included claims for negligent credentialing.

Billeaudeau v. Opelousas Gen. Hosp. Auth., 2018 La. App. LEXIS 751 (La. App. 2018).

Wells Notices and Subsequent Enforcement Action Deemed Claim First Made When SEC Investigation Began

A Texas state court granted summary judgement to an insurer, holding that no coverage was available for both a Wells Notice and an enforcement action brought by the SEC, when the original SEC investigation and shareholder litigations began in a prior claims-made policy period.

A group of shareholders filed a claim against the directors and officers of a technology company in June 2013. In November 2013, the SEC issue a formal order of investigation and subpoenaed the directors and officers for testimony and documents. In September 2014, the shareholders filed a derivative suit against the directors and officers alleging breach of fiduciary duty. In June 2015, the SEC sent Wells Notices to the company's directors and officers stating the SEC was recommending enforcement action against them based on the previous investigation. In March 2016, the SEC filed a lawsuit against the company. The insured submitted the lawsuit to its insurer under its then current policy. The insurer denied coverage, stating that lawsuit was related to the lawsuits and investigations that began in a prior policy period. Coverage litigation ensued.

The court granted summary judgment for the insurer, finding that a Wells Notice was clearly a claim, as defined. Further, the court noted that the Wells Notice here was issued at the end of long legal trail, rather than at the beginning. The policy at issue had a clear definition of "Interrelated Wrongful Acts" and the Wells Notices fell within that definition, "particularly as they concern acts which arose 'as a consequence' of the ongoing litigation and investigation."

UniPixel, Inc. v. XL Specialty Ins. Co., (Tex. Dist. Ct., Harris Cty, 2018).

Direct Loss

Nevada Federal Court Weighs in on Meaning of "Direct" in Commercial Crime Policy – Rules "Direct Means Direct"

In finding that a commercial crime policy did not provide coverage to an insured, the Nevada federal district court utilized a "direct means direct" rule to conclude that losses an insured suffered from payment card chargebacks were not covered under the policy.

The insured operated an adult entertainment club where customers could purchase "funny money" to tip waitresses or pay dancers. In turn, the waitresses and dancers could redeem the funny money for cash. Certain of the insured's employees overcharged customers' credit cards, including through purchasing extra funny money and then redeeming such funny money for cash, without the knowledge or consent of the customer. The scheme was ultimately discovered after multiple customers complained to the police and disputed the charges with their credit card companies. The insured paid the credit card chargebacks to the customers' credit card companies, both in response to its contractual requirements with such companies and also as part of an agreement with law enforcement. The insured also incurred significant professional fees to investigate and resolve the issues with law enforcement and defrauded customers.

The insured submitted the loss to its commercial crime insurer, and following a declination of coverage, litigation ensued.

The crime policy covered "loss of or damage to 'money', 'securities' and 'other property' resulting directly from 'theft' committed by an 'employee', whether identified or not, acting alone or in collusion with other persons." The insured argued that because the employees exchanged the "funny money" for cash from the insured, and because the insured had to reimburse customers for the fraudulent credit card charges, the employees stole from the insured and the loss was therefore covered under the policy. The insurer argued that the policy does not cover the employees' thefts because the insured was not a direct victim of the theft – instead the insured seeks to recover for its liability to the customers, which is not a covered loss.

The court, on summary judgment, agreed with the insurer, finding no coverage under the policy. The court noted that "[c]ourts addressing similar policy language about a loss resulting directly from an employee's theft have fallen into two camps," with some "view[ing] the policy language as equivalent to a proximate cause analysis" while "[o]thers employ the 'direct means direct' rule." Noting the absence of binding precedent in Nevada, the court predicted that Nevada's highest court would follow the "direct means direct" rule. The court reasoned that the "policy's plain language," which covered "direct" loss, supported this view, and it noted that "[i]f proximate cause were sufficient, that would render the word 'directly' superfluous." The court then applied the "direct means direct" rule and found that the loss to the insured did not directly result from the employees' theft, because there were intervening steps between the employees' theft and the insured's loss. More particularly, the court held, "(t)he policy thus contemplates a loss when the insured is deprived of property (either its own or property it holds as trustee or bailee), not when a third party is deprived of property and the third party later sues the insured or requires repayment under a contractual provision." In dismissing the action, the court noted that the direct "theft was of the customers' (or perhaps the credit card companies') funds, not [the insured's]."

CP Food & Bev., Inc. v. United States Fire Ins. Co., 2018 U.S. Dist. LEXIS 133331 (D. Nev. 2018).

Interrelated Claims

Coverage Precluded based on Broad Related-Claims Provision

This coverage dispute addressed whether certain lawsuits were related to earlier lawsuits, and therefore excluded based on the related-claims provision contained in a Directors and Officers Liability policy. The United States Court of Appeals for the Eleventh Circuit held in favor of the insurer and found that all the underlying claims were related under the extremely broad related-claims clause contained in the D&O policy. The provision at issue grouped claims "in any way involving the same or related facts," and "whether related logically, casually or in any other way." The court addressed the insured's argument that the court should consider the actual facts underlying the legal claims rather than looking solely to the allegations made in the pleadings to determine whether the multiple claims were related. The court rejected this argument, reasoning "there is no rule against relying solely on the complaint to determine whether there is any set of facts that could possibly give rise to coverage." The court further reasoned that the insured failed to point to any extrinsic evidence showing that the allegations made in the complaints were actually unrelated despite the fact that the insured "was better positioned than any of the insurers to present evidence from those underlying cases to strengthen its position." Next, the court addressed whether the underlying claims were related based on the allegations of the underlying complaints. The insured argued that the lawsuits were unrelated based on the identity of the plaintiffs or the time at which they were filed. The court rejected this argument, holding the because all the lawsuits described a continuing pattern of the same or similar bad behavior, the extremely broad related-claims provision applied to bar coverage.

Health First, Inc. v. Capitol Specialty Ins. Corp., 2018 U.S. App. LEXIS 23552 (11th Cir. 2018).

D&O Insurer Ordered to Defend Later Securities Lawsuits as Related to Earlier Claim

The U.S. District Court for the Southern District of Texas held that certain securities lawsuits filed against the insured, a publicly-traded healthcare corporation, were interrelated with an earlier lawsuit against the company, and therefore the Directors & Officers Liability ("D&O") insurer was obligated to cover the costs the insured incurred in defending all three lawsuits.

An article on the Seeking Alpha website suggested the insured company was overvalued and that its share price would likely go down. Subsequently, the stock dropped in value and the plaintiffs sued the insured and certain of its directors and officers, alleging that the insureds "made false and/or misleading statements and/or failed to disclose that": (1) the insured's claimed success rate for one of its procedures was inaccurate and the procedure "lacked recognition from any university, medical body, or insurance company;" (2) the insured "overstated its 2014 revenues;" and (3) the insured misrepresented its 2014 revenue growth rate. The complaint also discussed the Seeking Alpha post and the effect it had on the insured's stock price.

The following year, the insured filed amended financial statements with the SEC. Then, another shareholder filed a securities class action lawsuit against the insured and certain of its directors and officers, alleging that the company had overstated the value of its receivables and of its net income for the 2014 fiscal year. The complaint also referenced the Seeking Alpha post and the company's amended financial disclosures. Another shareholder filed a third securities class action for a different class period, alleging that the company's financial statements had misled investors about the company's revenue, expenses and general business operations. The third lawsuit likewise discussed the Seeking Alpha post and the corrective SEC disclosures.

The insured sought coverage for the three lawsuits under its D&O policy. The insurer accepted coverage for the first lawsuit, which was filed during the policy period, but denied coverage for the second and third lawsuits, claiming the later suits were separate claims, made and noticed after the policy's term. The insured sued the insurer for breach of contract and declaratory judgment contending that the three lawsuits were related and therefore covered under the earlier policy.

The policy broadly defined "Related Wrongful Acts" as "Wrongful Acts which are logically or causally connected by reason of any common fact, circumstance, situation, transaction, casualty, event or decision." The policy also stated that:

> [m]ore than one Claim involving the same Wrongful Act or Related Wrongful Acts of one or more Insureds shall be considered a single Claim. All such Claims constituting a single Claim shall be deemed to have been made on the earlier of the following dates: (1) the earliest date on which any such Claim was first made; or (2) the earliest date on which any such Wrongful Act or Related Wrongful Act was reported under this Policy or any other policy providing similar coverage.

The court found that the Wrongful Acts alleged in each of the three lawsuits were "united by common circumstance or situation" because, "[a]t their core, all three complaints are allegations that [the insured] inflated its stock price by making various misstatements to the investing public." The court said the insurer's differentiation focused "on minute differences in the complaints." The court also rejected the insurer's argument that the first lawsuit was different from the subsequent two because it was not based on the accounting errors that were set forth in the amended SEC disclosures. The court noted that the disclosure of the accounting errors was not itself a "Wrongful Act," rather, the "Wrongful Acts" alleged in the three lawsuits are primarily that the insured's financial statements contained inaccurate information. The court stated that the policy only required that the wrongful acts be connected "by reason of any common fact, circumstance, [or] situation" and found that:

> [t]he fact that the complaints contain some of the same "Wrongful Acts" is enough to trigger coverage. That the complaints also contain "Related Wrongful Acts" only strengthens [the insured's] position that coverage was withheld in breach of the Policy.

Nobilis Health Corp. v. Great Am. Ins. Co., 2018 U.S. Dist. LEXIS 171671 (S.D. Tex. 2018).

No Bad Faith or Breach of Fiduciary Duty in Denying Interrelated Claim

The U.S. Circuit Court of Appeals for the Tenth Circuit affirmed a lower court ruling that an insurer had not committed bad faith or breached its fiduciary duty when it denied a claim made against a financial services company on the basis that it was interrelated to other claims made prior to the inception of its policy.

Clients sued an investment firm alleging misrepresentation and mismanagement, among other state and federal violations. The firm submitted the claim to its financial services liability insurer. The insurer denied the claim because the allegations were identical to those made by the SEC against the insured prior to the inception of the policy. The parties settled the claim and the insured assigned it rights under the policy to the plaintiffs who then sued the insurer for bad faith and breach of fiduciary duty stating that the claims were too distinct from the prior claims to be excluded.

The court found that the broad language of the interrelated claims provisions included plaintiffs' claim even though the claims did not involve the same investment vehicles as the SEC action. Therefore, because the claims against the insured were not covered by the policy, there was no basis for bad faith or breach of fiduciary duty allegations. The plaintiffs' claims were appropriately dismissed.

Morden v. XL Specialty Ins., 2018 U.S. App. LEXIS 25595 (10th Cir. 2018).

Lawsuits Alleging Similar Wrongful Acts by Different Parties, During Different Time Periods, Constitute a Single Claim

The U.S. District Court for the District of Delaware ruled that two class action lawsuits alleging similar wrongful acts, albeit commenced by different classes for different class periods, were "related" and constituted a single claim under a fiduciary liability insurance policy.

On September 28, 2006, a class action lawsuit ("First Lawsuit") was filed against members of the insured's investment and administrative committees ("Insureds") by plan participants and beneficiaries for alleged breach of ERISA duties by permitting the plans to pay excessive administrative fees to the Insured and third-party service providers and similarly permitting the plans to pay excessive investment management fees for various funds offered by the plans including the "Emerging Markets Fund." The Insured notified its insurers of the First Lawsuit, which was accepted as a claim under the 2006-2007 policy period. Several years later, the plaintiffs sought to expand the class period but the court denied the request.

Soon after, another class action lawsuit ("Second Lawsuit") was filed against the Insureds by plan participants and beneficiaries. Just like the First Lawsuit, the Second Lawsuit alleged that the Insureds breached their ERISA duties by permitting the plans to pay excessive administrative fees to the Insured and third-party service providers and similarly permitting the plans to pay excessive investment management fees for various funds offered by the plans including the "Emerging Markets Fund." The Second Lawsuit complaint stated that the First Lawsuit was a "related case."

The Insured attempted to obtain coverage for the Second Lawsuit under its 2016-2017 policy period, but the primary insurer stated that the Second Lawsuit alleged wrongful acts (as defined by the policy) related to the wrongful acts alleged in the First Lawsuit and coverage for the Second Lawsuit properly belonged under the 2006-2007 policy period. The primary insurer's limit of liability for that period had been exhausted defending the First Lawsuit and a related Department of Labor investigation, so coverage was owed by the excess insurer if the Second Lawsuit belonged under the 2006-2007 tower. The excess insurer argued that the First Lawsuit and the Second Lawsuit were not related and coverage for the Second Lawsuit belonged under the 2016-2017 program. The Insureds filed suit against both insurers.

The 2006-2007 policy's Relation-Back provision provides, in pertinent part, that claims made after the policy period are considered "made" during the policy period if the claims "alleg[e] any Wrongful Act which is ...related to any Wrongful Act alleged" in any other claim made during the 2006-2007 policy period." Similarly, the 2016-2017 policy's Prior Notice Exclusion specifically excludes coverage for claims "alleging ... related Wrongful Act[s] alleged or contained [] in any claim which has been reported prior to the inception of this policy."

In applying the policy provisions to the underlying facts the court stated that claims are "related" if there is either a "logical" or a "causal" connection between them. In addressing the "logical" connection, the court stated that the allegedly offending behavior in both the First and Second Lawsuits was the administration of the retirement plans by the Insureds, and that "each case's operative complaint relates the same specific behaviors: the plans' payment of allegedly excessive administrative fees to [the insured company] and third party service providers, and the plans payment of allegedly excessive investment management fees on various funds within the plan, including the Emerging Markets Fund." The court observed that the excess insurer did not address the alleged specific behavior in the First and Second Lawsuits, but instead pointed out the differences in the parties and the attempt to recover for actions taken at different times. The court recognized that some members of the First Lawsuit class are not members of the Second Lawsuit class and vice-versa, but they likely largely overlap. Likewise, the court recognized that members of the Insureds' administrative and investment committees had changed over time, but "it does not change the fact because they all continued in the same course of allegedly illegal conduct." As for actions taken at different times, the court stated "the type of breaches alleged (and the damages alleged to have resulted) are all of exactly the same type and are, on their face, part of a single course of conduct."

The court determined that the excess insurer's argument concerning differences in the lawsuits was unpersuasive and decided that the First Lawsuit and Second Lawsuit included related Wrongful Acts and therefore the Second Lawsuit should relate back to the First Lawsuit covered under the 2006-2007 policy tower.

Northrop Grumman Corp. v. Axis Reins. Co., 2018 U.S. Dist. LEXIS 183804 (D. Del. 2018).

Loss

Settlement was Insurable Loss

The Delaware Supreme Court recently affirmed a previous decision of the Superior Court of Delaware, which had found that a settlement of a civil lawsuit was insurable loss despite the insurers' arguments that the amounts constituted disgorgement. In the underlying matter, the insured had settled several lawsuits brought by investors, and it consistently denied any wrongdoing or liability. The insured had been sued in three class actions that alleged that it did not credit customers' accounts with profits when certain transfer or withdrawal requests had been made by the client. The court noted that whether the "...allocation of gains and losses from its policy for handling transfer and sale requests was contractually proper, the reality is that it was a risk sharing arrangement that spread the costs and benefits of that policy among all of the funds' investors..."

Continues

The insurers sought a reversal of the lower court's determination that the amounts did not constitute uninsurable disgorgement. The cases cited by the insurers to support their positions all involved direct actions by regulatory agencies in which the insured was ordered to pay disgorgement damages which were linked to "...improperly acquired funds in the hands of the insured." They argued that the insured did not suffer a "loss" as defined under the Policy since "disgorgements" are not insurable under the public policy of New York and they cited several cases which were all based upon underlying regulatory proceedings.

In its findings, the court noted that there had been no finding that the funds received any ill-gotten gains and the underlying arrangement effectively spread all of the gains and/or losses amongst the investors thus not providing any opportunity for the insured to 'profit.' With this backdrop the court held that the Superior Court appropriately distinguished this case from one in which the wrongdoing resulted in ill-gotten gains and that such prohibition did not apply to the facts at hand.

In re TIAA-CREF Ins. Appeals, 2018 Del. LEXIS 358 (Del. 2018).

Professional Services

Differing Outcomes in TCPA Coverage Cases

The United States Court of Appeals for the Tenth Circuit and the District Court for the Eastern District of New York both decided cases regarding insurance coverage for Telephone Consumer Protection Act ("TCPA") claims with differing outcomes.

In the Tenth Circuit case, the court addressed coverage for a TCPA claim under a general liability policy after the carrier denied the claim. The insured sued, but the lower court found that the insurer did not have a duty to defend or indemnify the insured because the policy did not provide coverage for any of the claims asserted in the underlying TCPA suit. More importantly, the lower court found that the TCPA statutory damages were meant to penalize and therefore were uninsurable due to Colorado public policy. The Tenth Circuit upheld the lower court decision. Relying on a Colorado Supreme court decision, the court said the damages under the TCPA were penal because the under the TCPA the cause of action did not require proof of injury and the damage award was greater than any actual damage suffered. The insured argued that other courts have ruled that there are remedial and statutory elements of damages under the TCPA and as such, insurance policies could respond. The court disagreed, ruling that the provision for awarding statutory damages for TCPA violations is a penalty and therefore uninsurable under Colorado law.

The district court for the Eastern District of New York ruled on a TCPA case where the insured, a charter bus company, sought coverage under its professional liability policy. The insurer denied the claim. The underlying parties agreed to a settlement, which included an assignment of the coverage to the plaintiff, which filed for summary judgment. The insurer maintained that the insured's violation of the TCPA occurred when the insured was advertising its own services and not when it was offering those services for a fee. Therefore, the insured was not providing services for others for a fee, as required by the policy. The court disagreed, saying that the advertisement by the insured could be covered under the travel services operations provision of the policy as the advertisement was "necessary or incidental" to conducting the insured's travel agency business because the insured was in the business of securing fees for travel, lodging or guided tour accommodations. The insurer then argued the advertising services were not covered because they were not "unique" to the business of a charter bus company. The court said that there was no policy requirement that the services be unique and that given the plain language of the policy, it was sufficient that the activities were an essential part of the bus company business. The court held that the professional services policy covered the claim for the TCPA violations.

The reason for the differing outcomes in the two cases was not that one court evaluated the potential for coverage under a general liability policy and the other evaluated the potential for coverage under a professional services policy, but that the Tenth Circuit court's decision was based on public policy rather than insurance coverage. The Tenth Circuit focused on the nature of the damages awarded under the TCPA and whether public policy allowed for the insurability of such damages. The Eastern District of New York focused on whether the policy language provided coverage.

Ace American Ins. Co. v. Dish Network, LLC, 2018 U.S. App. LEXIS 4083 (10th Cir. 2018), *Ill. Union Ins. Co. v US Bus Charter & Limo,* 2018 U.S. Dist. LEXIS 38266 (E.D.N.Y. 2018).

"Tax Advice" Not a Covered Professional Service under a Life Insurance Agent's E&O Policy

A financial advisor's clients sued the advisor after the IRS deemed the advisor's recommended financial plan a tax avoidance scheme. The financial advisor placed its Life Insurance Agents Errors and Omissions ("E&O") insurer on notice of the suit and requested that the insurer defend and indemnify it for the clients' lawsuit. The insurer denied coverage stating that the definition of "Professional Services," which was incorporated within the definition of a "Wrongful Act," was not satisfied and there was no coverage. The advisor commenced suit against the insurer alleging (1) breach of the insurance policy and (2) breach of the covenant of good faith and fair dealing, or bad faith. Ultimately, the court agreed with the insurer and found that there was no covered "Wrongful Act" and no "Covered Product," as those terms were defined, so as to trigger any duty to defend.

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In conducting its analysis of the insurance policy, the court reasoned that, in order for coverage to be triggered, the clients' complaint was required to allege a "Wrongful Act" in the rendering/failure to render "Professional Services" solely related to a "Covered Product," which included life insurance, disability income insurance, and fixed annuities. The court determined that the underlying clients' complaint did not assert claims based upon or arising out of the advisors' financial planning or consulting services "solely" related to a "Covered Product." Instead the court found the underlying complaint alleged fraud and tort claims relating to the financial advisor's tax avoidance scheme (utilizing a limited liability company through which to pass tax liabilities), with no indication that such tax advice related to the tax consequences or benefits in obtaining life insurance or other insurance. In addition, the court cited to a specific "tax advice" exclusion in the policy. The court also took the liberty to point out to the insured the preamble of the policy, wherein the court admonished the insured "to read the entire policy to determine their rights and duties..." The court concluded that a careful reading of the plain language of the policy supported the insurer's denial of coverage.

Lindsey Fin. v. Am. Auto. Ins. Co., 2018 Cal. App. Unpub. LEXIS 3164, (Cal. Ct. App. 2018).

Ninth Circuit Finds Professional Services Exclusion Precludes D&O Coverage for Suit Alleging Improper Employee Bonuses

The United States Court of Appeals for the Ninth Circuit affirmed a California District Court's decision that an educational technology company's claim for defense and indemnification for a qui tam suit alleging the insured paid improper employee bonuses was excluded by the policy's "professional services" exclusion of the directors and officers liability policy.

The insured provides technology and support services to universities seeking to establish or expand their online education programs. These services primarily revolve around marketing the universities' online programs and recruiting students and faculty. Certain former employees of the insured filed a qui tam lawsuit against the insured on behalf of the federal government under the False Claims Act (the "FCA Lawsuit"). The plaintiffs alleged that the insured violated federal regulations concerning the enrollment of students who received federal financial aid, including a ban on incentive compensation, and caused both those students and the universities with which the insured partnered, to submit false claims for student financial aid to the federal government.

The insurer denied coverage and refused to defend the insured on the ground that the claims were excluded by the professional services exclusion, which excluded coverage for claims "alleging, based upon, arising out of, attributable to, directly or indirectly resulting from, in consequence of, or in any way involving the rendering or failing to render professional services." The insured ultimately settled the FCA Lawsuit and then sued the insurer for defense and indemnification, asserting breach of contract and breach of the duty of good faith and fair dealing. The insured argued that the FCA Lawsuit's claims were merely a matter of its employee compensation. The District Court granted the insurer's motion for judgment on the pleadings based on the "professional services" exclusion, concluding coverage was precluded by the exclusion because the bonuses affected the company's professional clients. The insured appealed.

The Ninth Circuit concluded that because the insured conceded that the services it provides to universities, including its recruitment services, are "professional services" within the meaning of the policy and California law, "the sole point of disagreement concerns whether the claims from the FCA Lawsuit 'aris[e] out of . . . [the insured's] rendering or failing to render professional services.'" The court agreed with the insurer and affirmed the lower court's ruling that the professional services exclusion precluded coverage for the FCA Lawsuit because the insured's "alleged liability derived from the fact that its professional services caused ineligible students and ineligible universities to submit claims for federal financial aid to the [Department of Education]." The court rejected the insured's argument that the relationship between its professional services and its alleged liability was merely "incidental" and instead found that the relationship was direct and well within the professional services exclusion's plain language.

HotChalk, Inc. v. Scottsdale Ins. Co., 2018 U.S. App. LEXIS 14884 (9th Cir. 2018).

Securities Definition

Federal District Court Upholds Securities Indictment Related to Initial Coin Offerings

The defendant was charged with promoting digital currencies that were purportedly backed by real estate and diamond investments that did not exist. The defendant asserted that he was offering merely investment opportunities in digital currency, the court found that the facts alleged in the indictment, on its face, satisfied the test articulated in SEC v. W.J. Howey Co., 328 U.S. 293, (1946), and therefore alleged an initial coin offering (ICO) was an "investment contract" – a form of security. Assuming the truth of the indictment, the court reasoned that "a reasonable jury could conclude that the facts alleged in the Indictment satisfy the Howey test" for a security. On this basis, the court permitted the government to proceed with the prosecution and the defendant was subject to further criminal prosecution.

[Author's Note] This is believed to be the first criminal case in which a federal court considered whether a cryptocurrency could be regarded as a "security" under the Securities Exchange Act. Although finding that the government's indictment was not subject to dismissal, it is important to note that the court held that the trier of fact must determine whether the ICO was a security.

United States v. Zaslavskiy, 2018 U.S. Dist. LEXIS 156574 (EDNY 2018).

Social Engineering

Coverage Excluded for Social Engineering Loss because Employee had Authority to Initiate Wire Transfer

The Ninth Circuit Court of Appeals affirmed a district court's decision that a crime policy excluded coverage for a social engineering loss because the insured's employee had the authority to initiate the wire transfer and entered the fraudulent account information.

In the underlying dispute, the insured's vendor's computer system was hacked. The hacker apparently monitored email exchanges between an insured employee and a vendor employee and intercepted those exchanges. The hacker then sent fraudulent emails using "spoofed" email domains that appeared similar to the employees' actual emails — for example, substituting the number "1" for a lower case "l." In these emails, the hacker directed the insured's employee to change the vendor's bank account information for future wire transfers. The insured's employee made the changes and unwittingly wired $713,890 to an account controlled by the hacker.

The insured submitted the loss under its crime insurance policy, which provided coverage for and defined Computer Fraud as: "the Insured's direct loss of, or direct loss from damage to, Money, Securities, and Other Property directly caused by Computer Fraud." The insurer denied the claim, stating that the loss was not directly caused by Computer Fraud and that several of the policy exclusions applied, including "loss or damages resulting directly or indirectly from the input of Electronic Data by a natural person having the authority to enter the Insured's Computer System..."

The insured sued the insurer asserting breach of contract. The district court granted the insurer's summary judgment motion on the ground that coverage was excluded because the insured's employees had authority to, and did, change the banking information in the insured's computer system. The court also found that entry of data into the insured's computer system was an indirect cause of the loss. The insured appealed.

Without deciding whether the loss constituted "Computer Fraud," the court held that the policy's exclusions precluded coverage. The court found that the loss "fits squarely within the Exclusion" because the insured's employees had the authority to enter the insured's system and "input" Electronic Data on the insured's computers in order to change the wiring information and authorize the subject wire transfers.

The court rejected the insured's argument that Washington's efficient proximate cause rule applied because that rule "applies only when two or more perils combine in sequence to cause a loss and a covered peril is the predominant or efficient cause of the loss." In this case, there is only one "peril"—Computer Fraud— and "[a]n insured may not avoid a contractual exclusion merely by affixing an additional label or separate characterization to the act or event causing the loss."

Aqua Star (USA) Corp. v. Travelers Cas. & Sur. Co. of Am., 2018 U.S. App. LEXIS 9660 (9th Cir. 2018).

Eleventh Circuit Finds No "Direct Loss" under Computer Fraud Coverage Section

The United States Court of Appeals for the Eleventh Circuit ruled in favor of an insurer, agreeing with the district court that the insurer's computer fraud coverage section of a commercial crime policy was not triggered.

The insured operates a network that allows consumers to put money onto reloadable debit cards issued by banks. It sells "chits" to consumers, which are used to transfer funds to their cards. After purchasing a chit, a consumer simply calls to redeem the chit and have its value moved over to the card. When a consumer dials the number to redeem a chit, he/she is connected to the insured's interactive voice response ("IVR") computer system.

Fraudsters exploited a vulnerability in the IVR system that enabled multiple redemptions of a single chit, by making two or more concurrent calls to the IVR system simultaneously requesting the redemption of a particular chit. One call would transfer the funds from the chit to the debit card account, while the other would return the chit to an "unredeemed" state, allowing it to be redeemed again. The fraudulent redemptions cost the insured over $10 million.

The insurance policy provided coverage for "loss of, and loss from damage to, money, securities and other property resulting directly from the use of any computer to fraudulently cause a transfer of that property from inside the premises or banking premises: (a) to a person (other than a messenger) outside those premises; or (b) to a place outside those premises." The insured sought coverage for the amounts lost to debit card holders who fraudulently manipulated the IVR system to effectuate duplicate redemptions of the chits.

The district court ruled in favor of the insurer on two grounds. First, the district court concluded that the fraud was not accomplished through "the use of a[] computer" within the meaning of the policy. In reversing that portion of the district court's ruling, the Eleventh Circuit remarked that the district court imposed additional conditions not required by the policy's plain language—for instance, that the computer "use" be knowing. The Eleventh Circuit explained that the plain meaning of the word "use" supports an understanding that encompasses the callers' access and manipulation of the IVR system (which uses computers to process consumer's voice requests or telephone touchtone codes). The court continued that the dictionary definitions of "use" (e.g., "take, hold, or deploy (something) as a means of accomplishing or achieving something; employ") "it seems to us, fit like a glove. Here, the callers clearly 'deploy[ed]'—or 'employ[ed]'—the IVR computer system as a means of accomplishing or achieving" fraudulent duplicate redemptions of the chits.

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Despite finding that the scheme perpetrated utilized a computer, the Eleventh Circuit analyzed whether the loss "result[ed] directly" from the use of a computer. It reviewed the dictionary definition of "directly," noting one dictionary's definition of "direct" as "(1) straight, undeviating; (2) straightforward; (3) free from extraneous influence, immediate; (4) of, relating to, or involving passing in a straight line of descent, as distinguished from a collateral line." The court continued that for purposes of the policy, one thing results "directly" from another if it follows straightaway, immediately, and without any intervention or interruption.

The court continued its analysis as to when the loss occurred. The Eleventh Circuit noted that four steps typically occurred in the chit redemption process: (1) a call was made to the 800 number to redeem a chit; (2) the insured transfers funds equivalent to the value of the redeemed chit to the bank that issued the debit card; (3) debit card users make purchases from a merchant, incurring a debt to be paid from the bank account; and (4) the bank transfers money from the account to the merchant to cover the purchase made by the card holder. While the insured argued that it sustained loss when it transferred funds to the bank, the Eleventh Circuit relied on evidence indicating the insured had the ability to intervene and halt the disbursement of funds until the bank transferred the funds to the merchants. Because "days or weeks – even months or years – could pass between the fraudulent chit redemption [step 1] and the ultimate disbursement of the fraud tainted funds [step 4]," the loss was too remote in time to "result directly" from fraud. The court determined that the lack of immediacy—and the presence of intermediate steps, acts, and actors—makes clear that the loss did not "result[] directly" from the initial fraud. The Eleventh Circuit therefore affirmed the district court's finding of no coverage.

Interactive Communs. Int'l, Inc. v. Great Am. Ins. Co., 2018 U.S. App. LEXIS 12410 (11th Cir. 2018).

Two Federal Appellate Courts Hold that Insurers Must Pay Claims for Wire Transfer Losses under Fidelity Policies' Computer Fraud Provisions

The United States Courts of Appeals for the Second and Sixth Circuits have held that two insurers must pay claims for wire transfer losses under their respective commercial crime policies' computer fraud provisions. Neither policy contained specific social engineering coverage.

In the Second Circuit action, the insured sued its insurer, claiming that its loss from an email "spoofing" attack was covered by its commercial crime insurance policy's computer fraud provision. The computer fraud section covered "losses stemming from any 'entry of Data into' or 'change to Data elements or program logic of' a computer system." The fraudsters' spoofed emails appeared, in all respects, to come from a high-ranking member of the insured's organization. The court rejected the insurer's argument that the insured did not sustain a "direct loss" as a result of the spoofing attack and held that New York courts generally equate the phrase "direct loss" to proximate cause. The court agreed with the district court that the plain and unambiguous language of the policy covers the loss. The court based its decision on the fact that the attack represented a fraudulent entry of data into the computer system because the spoofing code was introduced into the email system. The attack also made a change to a data element because the email system's appearance was altered by the spoofing code to misleadingly indicate the sender was the insured's president. The court affirmed summary judgment for the insured and declined to consider whether additional provisions in the policy might also provide coverage.

In the Sixth Circuit case, after receiving fraudulent emails that appeared to be from one of its vendors because of a similar domain name, the insured wired payments to a bank account it believed to be the vendor's but belonged to the fraudsters. The insured contended that it suffered a loss covered under its crime policy's "computer fraud" provision. The insurer denied the claim on the grounds that loss was not a "direct loss" that was "directly caused by the use of a computer," as the policy required.

Applying Michigan law, a Sixth Circuit three-judge panel rejected the insurer's arguments and held that the computer fraud provision covers losses from the insured's wire transfers sent based on the fraudulent emails. The court stated that the insured's loss was direct because it "immediately lost its money when it transferred the approximately $834,000 to the impersonator; there was no intervening event."

The insurer in the Sixth Circuit case filed a petition for rehearing or rehearing en banc (by the court's full panel) on the basis that the court wrongly applied a proximate cause analysis. The court denied the petition. The insurer in the Second Circuit case likewise petitioned for a rehearing and argued that the policy required direct causation and the court declined to rehear the case.

Medidata Sols. Inc. v. Fed. Ins. Co., 2018 U.S. App. LEXIS 18376 (2d Cir. 2018) and *American Tooling Ctr., Inc. v. Travelers Cas. & Sur. Co. of Am.,* 2018 U.S. App. LEXIS 19208 (6th Cir. 2018).

Loss arising from a Fraudulent Email Scheme Covered under a Business Owners' Policy

The U.S. District Court for the District of Montana found in favor of an insured that sought coverage under its Business Owners' Policy for losses it suffered as the victim of a fraudulent email scheme. The court found the exclusion relied upon by the insurer was ambiguous and ordered the insurer to pay the amounts specified in the policy.

The insured, an advertising company, was the unwitting victim of fraudulent emails received on four occasions. The purported sender of the four emails was the president of the company. Each email requested that various sums be wired to a designated bank account. The operations manager was the recipient of the emails and believed the emails were legitimate. She submitted the necessary written request to the bank to transfer the funds out of the company's account into the designated bank account. Unable to reverse the transactions with the bank upon learning of the fraud, the insured sought coverage under its Business Owners' Policy which provided coverage for Money and Securities, Forgery and Computer Fraud. The insurer declined coverage, citing the following "False Pretense" exclusion: "[w]e will not pay for physical loss or physical damage caused by or resulting from False Pretense: Voluntary parting with any property by you or anyone else to whom you have entrusted the property if induced to do so by any fraudulent scheme, trick, device or false pretense." The insured argued that the exclusion should not apply because it did not suffer a "physical loss" and that the loss was in the form of electronic funds and was thus intangible. The insurer maintained the insured improperly focused on the form of the money rather than the nature of the loss and argued the insured voluntarily transferred the money under false pretenses.

The court found the insurer's interpretation of the policy to be reasonable noting that "while the money was held in an intangible form while in the bank, it was no less money. Thus, the intangible funds were interchangeable with and represented what is tangible, i.e. money." In addition, the court noted that "once the money was electronically transferred out of the [insured's] account, it was gone. The [insured] no longer had physical access to or use of the funds, the same as if a stack of bills had been handed over to the fraudsters."

However, the insured pointed out there were different groups or categories of exclusions under the policy that make a distinction between "loss or damage" and "physical loss or physical damage." However, those terms were not defined, making the policy confusing as to what risks were covered and what risks were excluded. The court determined that because there were two different reasonable interpretations of the policy, the False Pretense exclusion was ambiguous and it construed the provision against the insurer. The court found that the Money and Securities and Forgery sections of the policy provided coverage. However, the Computer Fraud provision did not apply as it required a physical loss.

Ad Advert. Design, Inc., v. Sentinel Ins. Co., Ltd., 2018 U.S. Dist. LEXIS 165467 (D. Mont. 2018).

Part II: Exclusions

Capacity Exclusion

Capacity Exclusion Bars Coverage under Directors and Officers Liability Policy

A Delaware state court ruled that a capacity exclusion in a Directors and Officers Liability ("D&O") policy barred coverage for individual directors as the claims against them would not have existed 'but for' the individuals' misconduct related to a separate company that they controlled.

Two directors of a faltering company sought to reinvigorate the company through various purchase and financing arrangements utilizing two investment vehicles in which they had a personal investment. After the insured company ("Company") filed for bankruptcy, the Unsecured Creditors Committee commenced an action against the individual directors alleging breaches of fiduciary duties. The Unsecured Creditors Committee alleged that two directors breached their fiduciary duties and committed other acts in favor of their personal interest—through the two investment vehicles they created. The matter was tendered to the Company's D&O insurer, which denied coverage. The denial was based upon the 'capacity exclusion' wherein the alleged conduct was not "solely by reason of their status" as insureds of the Company due to their conflicts of interest with the independent investment vehicles. Coverage litigation ensued, and the directors argued that the exclusion should not apply as their alleged conduct was performed as directors of the insured Company even though a conflict of interest may have existed based upon their status with both investment vehicle companies. The insurer argued that the exclusion is applicable if the conduct forming the basis of the allegations "arises out of" an uninsured capacity.

The court reviewed the language and determined it to be clear and unambiguous and utilized a "but for" test in interpreting the "arising out of" language. The court

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ultimately held that the trustee's claims, on behalf of the Unsecured Creditors Committee, would have failed "but for" the alleged conduct related to their relationship with the uninsured investment vehicles.

Goggin v. Nat'l Union Fire Ins. Co., 2018 Del. Super. LEXIS 1533 (Del. Super. Ct. 2018).

Conduct Exclusion

California Supreme Court Rules That Insured Employers Are Entitled to CGL Coverage for Employees' Intentional Acts

An insured construction company was renovating a school during the school year and during that time its employee allegedly assaulted a 13-year-old student at the school. The victim filed suit against the employer alleging negligent hiring, retention and supervision of the employee. The insurer defended the insured pursuant to a reservation of rights, but maintained it had no obligation to defend or indemnify the insured in the matter due to the intentional acts of the employee. The district court granted summary judgment for the insurer on causes of action for negligent hiring, retention, and supervision. The insured appealed.

The court found the case turned on the definition of accident, which was central to the CGL policy's response. The court said that because a CGL policy provides coverage for bodily injury caused by an accident, it then provides coverage for the liability of the insured's negligent acts. The court also found that the employer's negligent acts in hiring, supervision, etc., were not the same as the employee's intentional acts. Therefore, the policy should respond to allegations of negligence against the employer arising out of an employee's intentional acts.

Liberty Surplus Ins. Corp v. Ledesma & Meyer Construction Co., 2018 Cal. LEXIS 4063 (Cal. 2018).

Contract Exclusion

Contract Exclusion Does Not Preclude Duty to Defend in Credit Card Breach Claim

An appellate court held that a contract exclusion did not bar coverage for a demand received by the insured arising out of a credit card breach. The insured is a retail chain that accepts payment from major credit card brands like MasterCard and Visa. The insured entered into a merchant agreement with a company that processes credit and debit transactions for a fee ("the card processor"). The insured's credit card network was subsequently hacked and the card processor had to reimburse issuing banks for the costs associated with the fraudulent transactions. The card processor sent a written demand for payment to the insured claiming that there was "conclusive evidence of a breach of the cardholder environment at [the insured]," and stating that "[the insured] was non-compliant with the Payment Card Industry Data Security [Standard] (PCIDSS) requirements." A second demand letter followed seeking reimbursement for additional fines and costs. The insured provided notice of the demand letters to its Management Liability Insurance Policy ("the policy"). The insurer initially refused to defend or indemnify the claim based upon an exclusion in the policy that provided that the insurance does not apply to "'Loss' on account of any 'Claim' made against any 'Insured' directly or indirectly based upon, arising out of, or attributable to any actual or alleged liability under a written or oral contract or agreement...." The insurer subsequently withdrew its denial and agreed to reimburse the insured for defense fees already incurred and to provide a defense going forward. The insured filed suit against the card processor to recover money the card processor withheld in reserve accounts.

The insurer complied with its obligations under a funding agreement for a few months but then refused to pay expenses associated with the litigation filed by the insured against the card processor "claiming they were not 'defense expenses' as they were incurred in pursuit of an affirmative claim against [the card processor]." The insured then filed suit against the insurer.

The insured and insurer disagreed over whether the allegations in the card processor's two demand letters give rise to the duty to defend or were barred by the contract exclusion. "[The insurer's] duty to defend is triggered if the Claim included the potential for liability on a non-contractual ground, even if the Claim may also have asserted contractual liability that would be barred by [the contract exclusion]." The court concluded that the demand letters included references to the insured's failure to comply with security standards and demands for non-monetary relief that were separate from the merchant agreement. The allegations "implicate theories of negligence and general contract law that imply [the insured's] liability ...separate and apart from any obligations 'based upon, arising out of, or attributable to any actual or alleged liability under' the Merchant Agreement." The insurer "emphasized the demand letters' references to [the insured's] indemnification obligation" pursuant to the merchant agreement. However, the court concluded that "its significance is outweighed by the references to non-contractual theories of liability contained in the letters, which must be construed in favor of [the insured] and the duty to defend."

Spec's Family Partners, Ltd. v. Hanover Ins. Co., 2018 U.S. App. LEXIS 17246 (5th Cir. 2018).

Broad Contract Exclusion Did Not Render E&O Coverage Illusory

The insured, a design/build firm, was sued by a client for alleging breach of contract for failure to properly design systems it purchased. The insured submitted the claim to its Errors and Omissions Liability policy that provided a duty to defend and indemnify for damages from "an act, error or omission in the rendering or failure to render" "those functions performed for others by you or by others on your behalf that are related to your practice as a consultant, engineer, architect, surveyor, laboratory or construction manager." The insurer initially defended under a reservation of rights, but later advised it would no longer defend the claim based on an exclusion that

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precluded coverage for all loss arising out of a breach of contract. The insurer sought a declaratory judgment affirming that it did not have a duty to defend the claim because any coverage that may have been available was eliminated by the breach of contract exclusion. The insured argued that the breach of contract exclusion was broader than the grant of coverage, and, therefore, the coverage was illusory.

The court found for the insurer stating that, despite the exclusion, there were several professional duties to which the policy would respond. In so finding, the court noted that the insurer agreed to provide coverage for negligent errors and omissions, not the insured's failure to meet contractual obligations.

Crum & Forster Specialty Ins. Co. v. GHD Inc., 2018 U.S. Dist. LEXIS 111827 (E.D. Wis. 2018).

Contract Exclusion in Directors and Officers Liability Policy Precludes Coverage for Negligence Claims arising from Insured's Alleged Breach of Contract

An appellate court held that a breach of contract exclusion in a directors and officers ("D&O") liability policy precluded coverage for a claim that included negligence and defamation claims in addition to the breach of contract claims. The insured entered into a contract for information technology services, but subsequently terminated that contract and entered into another contract with a different vendor. The first vendor sued the insured for breach of contract, negligence and/or intentional acts, which included defamation.

The insured submitted the claim for coverage to its D&O insurer, but coverage was denied in part based upon policy exclusions for breach of contract, defamation and mental anguish. The policy issued to the insured "explicitly excluded liability 'under or pursuant to any contract or agreement.'" The insured did not disagree that the policy excluded coverage for breach of contract claims. However, the insured argued that an exception to the exclusion where "such Insured would have been liable in the absence of such contract or agreement" provides a "but for" test to determine coverage and that the negligence and non-contractual claims provided for a separate basis for liability. The insurer argued that the first vendor failed to "allege any negligence claims that are separate and distinct from the breach of contract claims. [The insurer] contends that the only factually pled tort claim in the petition are for defamation; and the assertion of 'any and all other negligent and/or intentional acts' asserted . . . in the petition is merely a general allegation." The court agreed, finding that the negligent and intentional claims alleged stemmed from the contract between the insured and the first vendor. "These alleged claims would not have occurred but for the breach of contract by the [insured], and the claims are not separate and distinct from the breach of contract."

Accordingly, the court held that the allegations of "any and all other negligent and/or intentional acts" were excluded from coverage pursuant to the contract exclusion. In addition, the court determined that the policy's exclusions barred coverage for the defamation and emotional distress allegations.

Perniciaro v. McInnis, 2018 La. App. LEXIS 1720 (La. App. 4 Cir. 2018).

Contract Exclusion in Errors and Omissions Policy Precludes Coverage for Breach of Health Management Service Provider Agreement

This coverage dispute arose out of a breach of contract action brought against an insured that provides health management services to hospitals, health systems and physician groups. The insured was sued for breach of contract, breach of express warranty, unjust enrichment, and gross negligence. The plaintiff amended the complaint to omit all causes of action except breach of contract. The insured submitted the claim to its errors and omissions insurer. The insurer denied coverage primarily based upon the contract exclusion, which precludes coverage for "any liability in connection with any contract, agreement, warranty or guarantee to which an insured is a party, provided that this Exclusion [ ] shall not apply to Loss to the extent that such insured would have been liable for such Loss in the absence of such contract, agreement, warranty or guarantee." The insured argued that it assumed the duties and obligations of the contract through an assignment or transfer and "that an 'assignee' or 'transferee' is legally distinct from a party and the Court must narrowly construe the Contract Exclusion in its favor." The insurer asserted "that there is no meaningful difference between someone who assumes all the duties and obligations under a contract and a 'party' to a contract." The court agreed with the insurer and concluded that the case law presented by the insured did not hold or suggest "that an assignee is not a party to a contract in which it has duties, obligations, and rights. . . ." To the contrary, the court determined that the insured's cases were consistent with "a fundamental [ ] contract law principle that 'an assignee generally stands in the shoes of his assignor.'" The insured alternatively argued that the term "party" made the contract exclusion ambiguous. The court concluded that the insured did not demonstrate that the contract exclusion could have more than one reasonable interpretation and, therefore, was not ambiguous. Finally, the insured argued that the claim included alleged wrongful acts that occurred independently of the contract and prior to the assignment to the insured. The court again disagreed with the insured and held that the conduct occurred in connection with the contract and within the scope of the breach of contract exclusion.

Conifer Health Sols., LLC v. QBE Specialty Inc. Co., 2018 U.S. Dist. LEXIS 165063 (E.D. Tex. 2018).

Prior Acts Exclusion

"Prior Acts" Exclusion Not a Bar to Coverage

An insurer is responsible to pay its limit of liability under a Directors & Officers liability insurance policy with regard to a claim brought by the FDIC against the former directors and officers of a failed bank. The FDIC, as receiver of the failed bank, settled its claims against the bank's former directors and officers and then brought an action against the bank's D&O insurer for the policy's proceeds. The bank's woes began when the bank's regulators initiated an investigation into the bank's alleged unsound lending practices in one of its divisions. The

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investigated division was subsequently closed. Later, certain board members created a plan to hold and renovate certain foreclosed upon properties. The regulators approved the plan. Soon after, the bank's rating was downgraded, indicating that it would fail. The bank's board continued to invest millions of dollars into the properties despite the bank's impending failure.

The insurer sought to deny coverage based on the prior acts exclusion in the policy, arguing that there was a link between the original lending practices, which predated the retroactive date contained in the policy, and the hold and invest strategy later employed.

In arguing its case, the insurer primarily relied upon a previously decided case, *Zucker v. US. Specialty Insurance Company,* 856 F. 3d 1343 (11th Cir. 2017), which found that an insurer was exempt from paying the claim due to the application of the policy's "prior acts" exclusion in that matter as the claim " arose out of ... the Wrongful Acts prior to the policy inception." However, the court here said that the Zucker ruling does not apply because in this case the alleged wrongful acts were not interrelated such that the prior act exclusion would apply. The court noted that the continuing investment strategy was a separate decision from the original lending practices and therefore were independent wrongful acts that occurred during the policy period.

Certain Underwriters at Lloyd's of London v. FDIC, 2018 U.S. App. LEXIS 1934 (11th Cir. 2018)

Securities Lawsuit Alleging Wrongful Acts Across Multiple Policy Periods Excluded under Both Policies

This coverage dispute foused on whether a run-off Directors & Officers Liability policy and/or a "go-forward" D&O policy provided coverage for a securities claim alleging wrongful acts that occurred both prior to the run-off date and during the go-forward policy. After the insured was sued for securities violations that were alleged to have occurred during the period from February 14, 2011 through April 2, 2012, the insured noticed both its run-off policy and the go-forward policy. Both insurers denied coverage based on certain exclusions in their policies. The run-off policy excluded coverage for loss in connection with any claim "based upon, arising from or in any way related to any Wrongful Act committed or allegedly committed on or after December 1, 2011" (emphasis added). Meanwhile, the go-forward policy contained a prior acts exclusion that barred claims "based upon, arising out of, directly or indirectly resulting from .... any Wrongful Act committed or allegedly committed prior to December 1, 2011" (emphasis added).

The run-off insurer noted that in addition to the exclusion for wrongful acts occurring on or after December 1, 2011, the policy's insuring agreement was amended to cover claims only for wrongful acts taking place prior to December 1, 2011. Therefore, the insurer reasoned the exclusion in its policy must be taken to refer to "mixed" claims, i.e. claims that allege wrongful acts both before and after December 1, 2011, since if it were to refer to only wrongful acts committed on or after December 1, 2011, there would be no coverage at all. The go-forward insurer argued that the prior acts exclusion in its policy barred coverage since, based on the allegations of the securities complaint, it was the pre-December 1, 2011 fraudulent acts that caused each statement - even those after December 1, 2011 – to be false and misleading.

The insured countered that the policy language could not possibly mean what it said because it would mean no coverage for the securities litigation. The insured argued that the run-off policy and the go-forward policy must be "jointly construed to effectuate the intent of the parties." The court rejected this argument reasoning that the plain language of each of the policies clearly excluded coverage for the claims. The court also found the prior acts exclusion in the go-forward policy quite expansive. Thus, the court found in favor of both insurers and held that the insured was not entitled to coverage under either policy.

Jayhawk Private Equity Fund II LP v. Liberty Ins. Underwriters, Inc., No. 17-cv-5523 (C.D. Cal. June 7, 2018).

Prior Knowledge Exclusion

Prior Knowledge Exclusion Bars Coverage for Subsequent Claim

The United States District Court for the District of Maryland ruled an insured is not entitled to defense or indemnity from an insurer where the insured, during the underwriting process, responded it had no knowledge of facts which could give rise to a claim, despite prior receipt of a letter threatening litigation.

A closely-held company reorganized to form a new company, however, one of the original owners was excluded from the reorganized company. Upon learning of this, in November 2015, the ousted owner penned a letter to the remaining owners characterizing their conduct as "legally improper" and noted that it "could lead to a cause of action for breach of fiduciary duty, interference with a contractual relationship, interference with an economic relationship, civil conspiracy, and other potential causes of action." When the former owner was terminated (which he asserts was an effort by his former partners to force him to sell his shares) he filed suit alleging fourteen claims, both direct and derivative, including breach of fiduciary duty and tortious interference with economic relations. The original entity had two insurance policies for the policy periods of May 1, 2015 to May 1, 2016 and May 1, 2016 to May 1, 2017. On December 29, 2015, the insured submitted an application to add a newly formed entity. The 2015 application contained a "Prior Knowledge" question which provided: "With respect to each coverage currently purchased, did any Applicant or any natural person for whom insurance is intended have any knowledge or information, as of the 'date of coverage first purchased, 'of any error, misstatement, misleading statement, act, omission, neglect, breach of duty or other matter that may give rise or could have given rise to a claim." The insured responded "no" to this question despite knowledge of the letter from the ousted owner. The application also stated that "[i]t is agreed that if any such knowledge or information existed, any claim based on, arising from, or in any way relating

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to such error, misstatement, misleading statement, act, omission, neglect, breach of duty or other matter of which there was knowledge or information shall be excluded from coverage requested."

The insurer refused to defend or provide indemnity coverage for the underlying suit, which was tendered under the 16-17 policy and the insureds sued. The court ultimately concluded the insurer did not have a duty to defend or indemnify. In reaching this conclusion the court held that "as a threshold matter, the Court first considers whether the 2015 Application is part of the 2016 Policy," which the court concluded in the affirmative. Secondly, the court noted the "[ousted owner's] letter put Plaintiffs on notice of acts that could give rise to a claim" and the letter was directed to all of them and none of them disputes that he received it. "Consequently, the Prior Knowledge Exclusion bars coverage of the insurance claim related to the Underlying Action."

Madison Mechanical, Inc. v. Twin City Ins., 2018 U.S. Dist. LEXIS 55898 (D. Md. 2018).

Prior Threat of Litigation Operates to Bar Coverage under Prior Knowledge Exclusion

The United States Court of Appeals for the Sixth Circuit issued a ruling upholding a lower court decision that barred coverage where an email threatening potential litigation was received before the inception of the policy and where, during the application process, the insured denied knowledge "of any circumstances, acts, errors or omissions that could result in a professional liability claims against [the insured]."

The insured, a title agency, as part of a real estate transaction, accepted significant funds from multiple investors where an individual purchaser acquired foreclosed real estate and then sold the properties for half the market value to the investors. The insured served as an escrow agent maintaining the investor funds as earnest-money deposits with instructions to transfer the funds to the individual purchaser when the properties closed. When only a fraction of the properties that were promised had been obtained, the insured transferred amounts significantly more than needed to pay for the properties, resulting in damages to the investor.

The insurer issued a claims-made professional liability policy containing a "Known Circumstances Exclusion" (more commonly called the "Prior Knowledge Exclusion") which excluded coverage for any "'Professional Service' performed and those services that should have been performed or were omitted prior to the effective date of the Policy if any 'Insured' knew or could have reasonably foreseen that the 'Professional Service' could give rise to a 'Claim.'" The insured responded in the negative to the policy application inquiry regarding any knowledge of matters that could result in a claim. Before the policy incepted, however, the investor sent an email to the insured's principals and others that stated "I want you to know that unless suitable inventory or funds are returned by [date], I will take all action available against you. There will be no extensions ...; you must either deliver the suitable inventory or the money owed to me." The email further details the money allegedly owed and concluded "[i]f this does not happen by [date], I will begin to proceed with all civil and criminal action, both state and federal, against you [and others]."

The insurer declined coverage for the subsequent action, and a coverage action ensued. The court concluded that, based on the prior email, the complaint was foreseeable. Applying Michigan law, the court found the action by the investor for return of the funds was reasonably "foreseeable at the time of the email, since all the things necessary for that claim were there," "even if the claim had yet to germinate." The court rejected arguments that the email was merely a threat of a suit, because the author of the email "pledged consequences if his conditions were not met." The court also found the "obviousness of this threat could only have been strengthened by the fact that the other investors in [the individual's] scheme had also [previously] sued [the insured]."

Alterra Excess & Surplus Co. v. Excel Title Agency, 2018 U.S. App. LEXIS 20783 (6th Cir. 2018).

Prior and Pending Litigation Exclusion

In Connection with Ponzi Scheme, New York Court Narrowly Construes Prior and Pending Litigation Exclusion

A New York trial court recently ruled that an insurer must establish a common "fact, circumstance, situation, transaction or event" underlying a prior investigation before it can apply a prior and pending litigation or investigation ("PPLI") exclusion based on the earlier investigation. Further, the court ruled that the insurer cannot base its coverage denial on a common "fact, circumstance, situation, transaction or event" learned during the investigation.

The insured sought coverage for an SEC proceeding and criminal prosecutions that alleged defendants' involvement in a Ponzi-like scheme ("Underlying Prosecution"). One of the insurers asserted that it had no duty to defend or indemnify based on the exclusion, which provided that "[t]he Insurer shall not be liable to make any payment for Loss in connection with a Claim made against any Insured based upon, arising out of, directly or indirectly resulting from or in consequence of, or in any way involving: (1) any prior or pending litigation, administrative or arbitration proceeding, or investigation as of ..., or (2) any fact, circumstance, situation, transaction or event underlying or alleged in such litigation, administrative or arbitration proceeding or investigation; regardless of the legal theory upon which such Claim is predicated." An investigation and prosecution of the insured's founder for allegedly bribing the president of an association in order to secure an investment preceded the SEC's own investigation and prosecution.

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The parties agreed that a determination of whether the PPLI exclusion applied required a "side-by-side review," of facts that occurred before the date contained in the exclusion with facts alleged in the Underlying Prosecution, "[i]n order to ascertain whether a sufficient factual nexus exist." However, the court determined a "side-by-side review" was not required. Rather, the court explained, to deny insurance coverage based on a nexus with a "fact, circumstance, situation, transaction or event underlying ... [a prior] investigation," the insurer must at minimum show, as a matter of law, that (a) there existed an investigation prior to the operative date, (b) there was a common "fact, circumstance, situation, transaction or event" between that investigation and the subsequent litigation, and (c) this common "fact, circumstance, situation, transaction or event" was one that was "underlying" the prior investigation, under a strict and narrow interpretation of that term. The court concluded that it would be necessary for the insurer to show that a sufficiently common "fact, circumstance, situation, transaction or event" underlies both the government's earlier bribery investigation and the alleged Ponzi-like scheme prosecutions and proceedings. The court reasoned that there were no indications that, as of the relevant date, the investigation in any way included a fact, circumstance, situation, transaction or event concerning a Ponzi-like scheme within the insured, as the prosecution ultimately charged in the Underlying Prosecution. The court therefore concluded that the evidence failed to establish that the PPLI exclusion applied.

Freedom Specialty Ins. Co. v Platinum Mgt. (NY), LLC, 2018 N.Y. Misc. LEXIS 3891 (N.Y. Sup. Ct. 2018).

Prior Notice Exclusion

Coverage for Trustee's Lawsuit Against Former Directors and Officers Barred by Broad Specific Circumstances and Prior Notice Exclusions

In interpreting a "Specific Circumstances Exclusion Endorsement" and a "Prior Notice Exclusion," the U.S. District Court for the Northern District of California ruled that the broad language contained in those exclusions precluded coverage under a Directors and Officers liability ("D&O") claims-made policy.

The first insurer issued a D&O policy for the period March 24, 2015, to March 24, 2016 ("First Insurer Policy"), to a not-for-profit ("Company") that matched birth mothers with adopting parents and provided counseling services to adopting parents. During the First Insurer Policy, the California Department of Social Services issued a Complaint Investigation Report ("CDSS Report") concerning accusations by adopting parents that the Company was not financially able to provide the promised services. The CDSS Report stated that an investigation would be conducted concerning the accusations. The Company noticed the CDSS investigation as a circumstance under the First Insurer Policy. The Company then purchased, from a second insurer, a D&O policy for the period March 24, 2016, to March 24, 2017 ("Second Insurer Policy").

On February 3, 2017, the Company filed for bankruptcy. On March 21, 2017 (during the Second Insurer Policy), the Bankruptcy Trustee sued seven of the Company's former directors and officers alleging breach of fiduciary duty and negligence based upon financial mismanagement and referenced the adopting parents' complaints that the Company failed to provide promised services and continued to accept fees from newly signed adopting parents when they knew or should have known that the Company could not perform its outstanding obligations to those who had already paid for services ("Trustee's Suit"). The Bankruptcy Trustee also sued the second insurer alleging that the Second Insurer Policy covered the liability of the directors and officers of the Company.

The first insurer agreed to defend the Trustee's Suit under a reservation of rights because the complaint "shares facts or circumstances in common with the acts or circumstances alleged in the CDSS Report" which was noticed and accepted as a circumstance under the First Insurer Policy. However, the first insurer stated that the Trustee's Suit also "alleges numerous other facts and circumstances not alleged in the CDSS Report." Ultimately, the first insurer commenced a lawsuit against the second insurer seeking reimbursement for defense costs and an order to contribute its equitable share. On motion, the second insurer asserted that it did not have a duty to defend the Company by virtue of two exclusions in the Second Insurer Policy—each of which, according to the second insurer, independently barred coverage for the Trustee's Suit and requested dismissal of the contribution claim of the first insurer.

The Second Insurer Policy contained a "Specific Circumstances Exclusion" which excluded coverage for claims "based upon, arising out of, relating to, directly or indirectly resulting from, or in any way involving" the CDSS Report. The court stated that the exclusionary language was "extremely broad" and was plainly intended to exclude coverage. Focusing on the phrase "in any way involving" the court stated that "[o]f course the Trustee's Suit 'in any way involves the CDSS Report.'" The court stated that the CDSS report stemmed from the allegation that the Company was "not financially able to provide the services which it offers" and the "Trustee's Suit elaborates on this same allegation." The court stated that the existence of other allegations in the Trustee's Suit not specifically addressed in the CDSS Report was irrelevant because "[n]othing in the endorsement limits the 'in any way involving' language" in the exclusion as suggested by the first insurer.

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The Second Insurer Policy also contained a "Prior Notice Exclusion" that provided the second insurer "will not be liable . . . to make any payment of any Loss in connection with any Claim made against any Insured . . . based upon, arising out of, relating to, directly or indirectly resulting from or in consequence of, or in any way involving (emphasis in original) any Wrongful Act or Related Wrongful Act or any fact, circumstance or situation which has been the subject of any notice given (emphasis in original) under any policy of which this Coverage Part is a renewal or replacement." The second insurer asserted that the Trustee's Suit "does indeed involve the very same fact, circumstance, or situation the CDSS investigated: [the Company's] financial inability to perform its services." Likewise, the second insurer asserted that "the exclusion only requires the Trustee's Suit share "any fact" with the allegation that CDSS investigated." The court agreed that the Trustee's Suit "involve[es] the fact of the [the Company's] inability to perform services in light of its financial circumstances, which was the subject of the notice" provided to the First Insurer Policy.

Relying upon the exclusionary language, the court ruled that each of the broad exclusions alone barred coverage under the Second Insurer Policy for the Trustee's Suit and granted the motion to dismiss of the second insurer.

Landmark Am. Ins. Co. v. Navigators Ins. Co., 2018 U.S. Dist. LEXIS 211447 (N.D. Cal. 2018).

Securities Exclusion

Allegations Found to Bear "Incidental Relationship" to Securities Exclusion, Barring Coverage in Connection with Sale of Securities

A Texas federal district court held that a broadly-worded securities exclusion barred coverage for claims that were, at a minimum, "incidental" to the alleged misrepresentations made in connection with the sale of securities. In the underlying action, the plaintiffs entered an agreement to sell their interests in the insured company to a separate holding company. The holding company filed suit against the plaintiffs alleging that the plaintiffs made false representations during negotiations and in the equity purchase agreement. The plaintiffs sought coverage under the policy as insured directors and officers of the company. The insurer denied coverage on the basis that the claim at issue neither satisfied the definition of a wrongful act nor was saved by the exception language to the securities exclusion.

The insurer issued a management liability policy with directors and officers coverage to a company indirectly owned by the plaintiffs based on their ownership interests in certain closely held companies. In the ensuing coverage litigation, the court examined whether the claim satisfied the definition of wrongful act, which was defined in part as "any actual or alleged error, misstatement, misleading statement, act, omission, neglect, or breach of duty by any Insured Person in their capacity as such or in an Outside Position." The court analyzed whether the plaintiffs were alleged to have acted in their insured capacity – as an officer or director - or rather solely as sellers of their equity interest in the holding companies. The court found that it was not "unreasonable" to read the allegations as "potentially alleging that the [plaintiffs] committed at least one 'error, misstatement, misleading statement, act, omission, neglect, or breach of duty' in their insured capacity." As a result, the court found that coverage was triggered under the policy.

The court next analyzed whether the policy's securities exclusion precluded coverage. The securities exclusion barred coverage for any claim "based upon, arising out of or in any way involving...the actual, alleged or attempted purchase or sale, or offer or solicitation of an offer to purchase or sell, any debt or equity securities." Noting that the policy contained broad "arising out of" language in connection with the securities exclusion, the court found that a "claim need only bear an incidental relationship to the described conduct for the exclusion to apply." The court determined that the exclusion applied as all of the allegations bear, at the very least, "an incidental relationship to the sale of [plaintiffs] [equity] interest..."

The securities exclusion, however, contained an exception, which stated that the exclusion shall not apply to claims "based upon, arising out of or in any way involving the purchase or sale, or offer or solicitation of an offer to purchase or sell, any debt or equity securities in a private [] placement transaction exempt from registration under the Securities Act of 1933, as amended." The court found the exception did not apply as the '33 Act exempts from registration "transactions by an issuer not involving any public offering," and since the plaintiffs merely resold previously issued securities, they did not constitute "issuers" under the '33 Act.

Gleason v. Markel Am. Ins. Co., 2018 U.S. Dist. LEXIS 11608 (E.D. Texas 2018).

Texas District Court Applies Securities Exclusion to Bar Coverage

A federal district court in Texas recently ruled on the applicability of a securities exclusion under a private company Directors and Officers liability policy. The insureds had been owners in a company that they sold to a third party. The purchasers sued them alleging that they made false representations in the purchase agreement as well as during the negotiations.

The insurer denied coverage on the basis that the matter was not brought against the individuals in an insured capacity and based on the securities exclusion contained in the policy, which provided that the insurer was not liable for loss "based upon, arising out of or in any way involving (1) the actual, alleged or attempted purchase or sale, or offer or solicitation of an offer to purchase or sell, any debt or equity securities." The court held that the claims were barred by the exclusion and declined to find that the matter fell within an exception to the exclusion for "any Claim... based upon, arising out of or in any way involving...a private placement transaction exempt from registration under the Securities Act of 1933..."

The insured sought reconsideration as there had been no analysis by the court as to whether the facts fit within Section 4(a)(1) of the Securities Act of 1933, which provides that "transactions by any person other than an issuer, underwriter, or dealer" are considered to be exempt transactions. The court declined to consider this argument on reconsideration.

Gleason v. Markel Am. Ins. Co., 2018 U.S. Dist. LEXIS 135487 (E.D. Tex. 2018).

Specific Litigation Exclusion

DOJ Investigation Constitutes Seven Separate "Claims" Under Directors and Officers Liability Policy but is Excluded from Coverage Due to Specific Litigation and Pending or Prior Litigation Exclusions

A federal appeals court held that the insured's Directors & Officers (D&O) liability insurer did not have a duty to reimburse the insured for defense costs incurred responding to a Department of Justice (DOJ) investigation. The DOJ commenced an investigation after whistleblowers filed qui tam lawsuits against the insured for unlawfully encouraging health care providers to submit false or fraudulent claims to health insurers and for providing kickbacks to those health care providers. The insured settled with the DOJ and submitted a claim to its D&O liability insurer for reimbursement of its defense costs. The insurer denied coverage asserting that the DOJ investigation was related to the earlier qui tam lawsuits, which were listed in the policy's specific litigation exclusion in addition to being excluded pursuant to the pending or prior litigation exclusion. The court rejected the insured's argument that the insurer was obligated to advance all of the insured's defense costs. The court advised that the insurer did not have a duty to defend but had a duty to reimburse for defense fees related to the defense of covered claims.

The court determined that the DOJ investigation did not constitute a single claim, viewing the investigation as seven separate claims, one for each of the alleged "wrongful acts, errors or omissions" by the insured. The court found that five of the clams were related to the earlier qui tam suits and, therefore, were excluded by the specific litigation exclusion and/or the pending or prior litigation exclusion. The court further held that the insured did not put forth any evidence to show that the DOJ investigated the remaining two claims before the policy expired to demonstrate that they were claims made during the policy period and entitled to coverage.

Millennium Labs. v. Allied World Assur. Co. (U.S.), 2018 U.S. App. LEXIS 5782 (9th Cir. 2018)

TCPA Exclusion

Court Finds Insurer's Denial of Coverage Under Cyber Policy for TCPA Claims was Proper

The insured was sued for sending thousands of purportedly unauthorized text messages to consumers allegedly in violation of the Telephone Consumer Protection Act ("TCPA"). Soon after the filing, the insured entered into a consent judgment and settlement agreement with the class of persons receiving the unauthorized text messages. The insured tendered the action to its insurer which denied coverage for defense and indemnity based upon two exclusions. The first exclusion ("Exclusion CC") barred coverage for any claim "alleging, based upon, arising out of or attributable to any unsolicited electronic dissemination of faxes, emails or other communications by or on behalf of the Insured to multiple actual or prospective customers of the Insured or any other third party, including but not limited to actions brought under the Telephone Consumer Protection Act...." The second exclusion ("Exclusion Y") barred coverage for claims "...alleging, based upon, arising out of or attributable to false, deceptive or unfair business practices or any violation of consumer protection laws."

The insured challenged the insurer's denial of coverage under its cyber liability policy for defense and settlement expenses incurred. In the coverage action the insured contended that Exclusion CC was not sufficiently broad to encompass the individualized messages at issue, which were alleged to have been tailored to each individual class member based upon their recipients' individual experiences with the insured. The court summarily disagreed and held that the exclusion "...precludes coverage for claims arising out of unauthorized communications sent by the insured 'to multiple actual or prospective customers,' and explicitly precludes coverage for actions brought under the TCPA." The court did not agree with the insured's attempted thwarting of Exclusion CC's application through its argument that the text messages sent to plaintiffs were not identical and were not sent at the same time – for, as the Court explained, Exclusion CC did not require the text messages "be identical or sent at the same time" and "explicitly precludes coverage for actions brought under the TCPA." Similarly, the court held that the TCPA is a consumer protection statute and Exclusion Y serves as a separate basis to deny coverage.

Flores v. ACE Am. Ins. Co., 2018 U.S. Dist. LEXIS 73629 (S.D.N.Y. 2018).

Part III: General Insurance Provision

Additional Insured

Delaware Superior Court Rules that Additional Insured on Directors & Officers Policy Entitled to Defense Costs Advancement

A company providing management and advisory services to a Real Estate Investment Trust ("REIT") was entitled, as an additional insured, to have its costs of defending underlying claims advanced under the REIT's directors & officers insurance policy—despite competing claims to the D&O insurance proceeds.

In 2011, the REIT retained an entity to provide management and advisory services ("Advisory Services Company"). However, following the REIT's financial restatements, the Securities and Exchange Commission ("SEC") commenced an investigation of the REIT. The SEC also issued a subpoena to the Advisory Services Company, demanding documents regarding the Advisory Services Company's external management of the REIT and its knowledge of the REIT's finances. Further, REIT shareholders filed securities class action lawsuits against the REIT, the Advisory Services Company, and both companies' directors and officers. REIT shareholders also filed opt-out lawsuits against the REIT and the Advisory Services Company.

In connection with the REIT's retention of the Advisory Services Company, the REIT agreed to add the Advisory Services Company to its D&O policy as an additional insured. The definition of the term "Company" was amended by endorsement to include the Advisory Services Company. When the investigation and lawsuits arose following the restatements, the Advisory Services Company and the REIT submitted the matters to the D&O insurers as claims under the program. The insurers commenced funding the defense.

Since the policy was issued to the REIT, the Advisory Services Company submitted its defense fees to the REIT for the REIT to, in turn, submit to the insurers. However, the Advisory Services Company contended that, at some point in time, the REIT failed to submit additional invoices for payment to the insurers—to ensure policy proceeds were available to the benefit of the REIT—and to the detriment of the Advisory Services Company. As a result, the Advisory Services Company initiated litigation against the insurers on the D&O tower, seeking a declaration that it was entitled to have its defense costs advanced similar to the REIT's. The REIT intervened, commencing an action against the Advisory Services Company, to "... protect its interest in the finite amount of available insurance proceeds."

Following numerous motions, the Delaware Superior Court ruled that the Advisory Services Company was entitled to Side C coverage (entity securities claim coverage) and therefore permitted to have its defense costs for a majority of the underlying matters advanced—subject to later repayment if coverage was ultimately determined to be unavailable. In this regard, the court rejected several of the REIT's arguments, including that the policy's additional insured endorsement running in favor of Advisory Services Company was intended to only apply to the Advisory Services Company's directors and officers under Coverage Side B (reimbursement coverage) but not for the company itself under Coverage Side C. The court rejected this argument, noting that the endorsement added the Advisory Services Company as an additional named insured by including it within the policy's definition of the term "Company." Despite finding the additional insured endorsement ambiguous, the court reasoned that based on the conduct of the parties and the policy's deciphered intent, the additional insured endorsement was intended to cover the Advisory Services Company for both Side B and Side C coverage. Moreover, if the parties to the policy had wanted to exclude Advisory Services Company from the Side C coverage, "they could have simply stated so in the Endorsement."

The court also rejected the REIT's argument that because the underlying claims did not involve the Advisory Services Company's securities (and only involved the REIT's securities), the claims did not meet the definition of Securities Claim triggering Side C coverage.

AR Capital, LLC v. XL Specialty Ins. Co., 2018 Del. Super. LEXIS 1568 (Del. Super. 2018).

Advancement of Expenses

Court Requires Excess D&O Insurers to Advance Insureds' Defense Costs

This coverage dispute arose out of an insured's D&O excess insurers' refusal to advance the insureds' attorneys' fees and costs to defend a criminal prosecution by the United States Attorney for the Eastern District of New York (the "EDNY Indictment"), a civil enforcement action by the Securities and Exchange Commission (the "SEC Complaint"), and a parallel civil action in Texas state court. The insureds' primary insurer and first excess insurer acknowledged coverage and advanced defense fees until the exhaustion of their respective policies. The remaining three excess insurers denied coverage based upon the insureds' alleged breach of warranty statements, in which the insureds allegedly falsely represented on the application for coverage that they were not aware of any wrongful act that may result in a claim being made. The insurers alleged that the warranty statements were breached by the insureds' failure to disclose the allegations contained in the EDNY Indictment and SEC Complaint, specifically, that the insured defrauded potential investors with material misrepresentations and omissions regarding the value of the insured's assets and liquidity. The insurers further argued that the insureds received a subpoena in 2015 from the United States Attorney for the Southern District of New York (the "SDNY Subpoena") in connection with an investigation of a former

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executive accused of paying a bribe to a public official. The insureds responded that: (1) the subpoena did not relate to any of the alleged wrongful acts in the pending EDNY Indictment and SEC Complaint and (2) no insured was charged with wrongdoing as a result of the SDNY Subpoena. The insurers also asserted that the "Pending or Prior Demand or Litigation Exclusion" (the "PPL Exclusion") applied, arguing that the pending actions "share a common nexus of facts and circumstances" to the SDNY investigation into the bribery scheme.

The court disagreed with the excess insurers because the insureds had not been found guilty of any charges in the EDNY Indictment or the SEC Complaint. "Until there has been a final adjudication of wrongdoing by the Insureds, the Excess Policies remain in effect and the Excess Insurers are required to pay the legal defense costs of their insureds. Likewise, a failure to disclose the subpoena in the SDNY investigation has not been shown to constitute a breach of the Warranty Statements." In addition, the court found that the "Insurers made no attempt to compare the facts and circumstances alleged in the SDNY investigation...with those alleged in the EDNY Indictment and SEC Complaint..." Therefore, the excess insurers have not shown that the PPL Exclusion is applicable.

Freedom Specialty Ins. Co., v. Platinum Mgmt. (NY), LLC., 2017 N.Y.Misc. LEXIS 5165 (N.Y. Sup. Ct. 2017).

Bad Faith

Statute of Limitations Period Begins When an Insured Can Plead Prima Facie Elements of Bad Faith Case

The Delaware Supreme Court held that under Delaware law, the statute of limitations, in a bad faith action under Louisiana law, begins to run when an insured can plead a prima facie case.

The insured, a Delaware company that operated a company in Louisiana, was sued in a number of matters, in as early as 2004, for violations of the preferred provider organization statute in Louisiana ("PPO Claims"). Ultimately, the PPO Claims settled in 2011, but the Errors & Omissions Liability ("E&O") insurer denied coverage asserting the defense of late reporting. The insurer filed a declaratory judgment action to confirm its position (which was ultimately unsuccessful for the insurer).

In addition the declaratory judgment action-which found coverage in favor of the company, the company sued the E&O insurer for bad faith. The lower court granted the insured's summary judgment motion premised on Louisiana's bad faith statute. The insurer appealed, claiming, in part, that the three-year statute of limitations expired on the bad faith statute.

Despite the lower court agreeing with the insured that a bad faith claim did not accrue until the coverage action had been decided, thereby triggering the beginning of the statute of limitations period, the Delaware Supreme Court disagreed. The Delaware Supreme Court held that the insured had a bad faith claim not when the coverage action was decided in 2016, but in 2011 when 1) it had a claim for indemnification for loss; 2) when the insurer knowingly misrepresented pertinent facts or insurance policy provisions related to coverage; and 3) when the insured suffered damages "as a result of" the insurer's misrepresentation (when it settled the underlying case).

Homeland Ins. Co. v. Corvel Corp., 2018 Del. LEXIS 513 (Del. 2018).

Disgorgement

'Disgorgement' Settlement with SEC Not Covered Under an Errors and Omissions Policy

This case concerned whether a disgorgement payment to the Securities and Exchange Commission (SEC) was covered under an Errors and Omissions (E&O) policy - where the disgorgement was linked to gains of non-insured parties as opposed to the insured. The insured received Wells notices from the SEC indicating its intent to commence civil proceedings for violation of federal securities laws relating to allegations of facilitating late trading and deceptive market timing on behalf of hedge-fund customers. The insured entered into a settlement with the SEC whereby it did not admit or deny the allegations, but agreed to pay a nine-figure disgorgement settlement, and an eight-figure penalty. Not surprisingly, private class action lawsuits followed the SEC case, and resulted in a settlement and significant defense costs.

The insured sought coverage from its E&O insurers for all such amounts, excluding the penalty and a portion of the disgorgement payment attributable to the insured's own alleged gains. The E&O insurers denied coverage for the portion labeled as disgorgement per the agreement with the SEC. Originally, the highest state court had found that public policy did not preclude coverage because the evidence did not conclusively establish that the payment was predicated on funds the insured improperly earned as a result of its alleged securities violations. However, subsequently, the United States Supreme Court held in an unrelated matter that an SEC disgorgement remedy is a penalty. The insurers cited to the Supreme Court's decision to argue against coverage. The intermediate appellate court agreed and held that the insured was not entitled to coverage for the entire disgorgement payment. The court found that the U.S. Supreme Court's decision established that disgorgement is a penalty, whether it is linked to the wrongdoer's gains or gains of others. And, because disgorgement is a punitive sanction intended to deter, the insured cannot pass on its loss emanating from the disgorgement payment to an insurer.

J.P. Morgan Sec., Inc. v. Vigilant Ins. Co., 2018 N.Y. App. Div. LEXIS 6130 1465 (N.Y. App. Div. 2018).

Estoppel

Kansas Supreme Court Refuses to Consider Estoppel Argument at Summary Judgment Stage

The Supreme Court of Kansas determined that the lower courts' grant of summary judgment in favor of the insurer was inappropriate because of outstanding issues of fact.

The underlying case involved legal malpractice by an attorney who represented an individual who ultimately loaned $5.6 million to a borrower for her business. The attorney was engaged to represent the lender in the loan transactions but failed to perform a UCC search on the collateral provided to secure the loan. The attorney was therefore unaware that a bank already held a security interest in the collateral.

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In December 2011, the lender learned of the bank's 2007 security interest and in a February 2012 email, the lender fired his counsel based on allegations of the attorney's "monumental errors" in the lending transactions. The lender also requested a copy of the attorney's file and requested that the attorney file a claim with her malpractice insurance carrier. The attorney did not advise her insurer and failed to disclose the allegations in the subsequent insurance renewal.

On November 12, 2012, the lender sent a demand letter to his counsel, who notified her insurer a week later. On November 29, 2012, the insurer's adjuster received documents including the February 2012 email. The adjuster advised his insured that he did not see any coverage issues and requested additional information, which he did not receive until February 2013. On January 11, 2013, the lender filed suit against the insured.

The insurer reserved rights in a letter dated March 11, 2013 and then declined coverage on April 16, 2013. The insured confessed judgment and assigned all of her rights to sue the insurer. A bad faith lawsuit against the insurer was filed shortly thereafter. The court granted summary judgment for the insurer, which was upheld on appeal.

The Kansas Supreme Court considered whether the insurer was estopped from asserting coverage defenses. The insured argued that estoppel was appropriate because the reservation of rights letter of March 11, 2013 was not issued timely. The court acknowledged that "estoppel...can be barred by (among other things) the insurer's adequate reservation of rights." Because the timeliness of a reservation of rights letter is a question of fact, the court determined that summary judgment was inappropriate; and reversed and remanded it to the district court.

Becker v. Bar Plan Mut. Ins. Co., 2018 Kan. LEXIS 574 (Kan. 2018).

Insurability

Despite Finding of Fraud, Neither Delaware Law nor Delaware Public Policy Relieves Insurers from Indemnification Obligation

In an opinion that may have far reaching implications, a Delaware Superior Court judge determined, among other rulings, that an underlying determination that an insured committed "fraud" and engaged in "fraudulent activities" does not make the claim uninsurable as a matter of Delaware law.

In the underlying action, stockholders of a food company (the "company") alleged that the defendants engaged in a lengthy process that manipulated the stock price so that company Chief Executive Officer (CEO) could acquire the company's stock at a lower price. The CEO sought to acquire the remaining stock of the company in order to take the company private. In an August 27, 2015 opinion, Delaware Vice-Chancellor Travis Laster found that the CEO and Chief Operating Officer committed "fraud" and engaged in "fraudulent activity" in connection with the take-private transaction. The Vice-Chancellor further found that the defendants breached the duty of loyalty and assessed liability in the amount of $148,190,590.18.

Following the assessment of liability and damages, defendants informed the company's directors & officers liability insurers that the company was considering settlement and mediation and requested that the excess insurers consider funding a settlement. All of the insurers responded, citing various exclusions in the policy and requesting more information from the company. Thereafter, the company signed a term sheet settling the underlying action –- in lieu of an appeal, the parties settled for 100% plus interest, and the CEO agreed to pay the settlement on the defendants' behalf. Shortly thereafter, defendants also mediated and settled (with notice to and involvement of the insurers) a separate litigation arising from similar claims.

The company's excess insurers in continuing to litigate their declaratory judgment action, contended that they were not required to provide coverage for the insureds because based on the findings of fraud Delaware and California law do not permit insurability as a matter of public policy. The court did not re-litigate the issue of whether the executives "engaged in fraud," finding that the prima facie elements necessary for collateral estoppel were satisfied in the underlying action on that issue. In a prior ruling, the court held that since the Vice-Chancellor's finding of fraud did not become part of the post-settlement final judgment, the policy's fraud exclusion did not preclude coverage for the settlement.

The determination of which states' law applied may have determined the outcome of the public policy indemnification issue. The court noted that Delaware and California law conflict regarding whether an insurance policy covers a director's or officer's willful or wanton actions. The insurers, in arguing that they cannot be liable for a loss related to a fraud, attempted to rely on Cal. Ins. Code §533 (Section 533), which provides that an "[a]n insurer is not liable for a loss caused by the willful act of the insured's agents or others" and Section 533 is "an implied exclusionary clause which by statute is read into all insurance policies." Conversely, the insureds noted that Delaware does not have a similar statute and the Delaware code provides that "a corporation shall have the power to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent of the corporate against any liability ... whether or not the corporation would have the power to indemnify such person against such liability under this section."

After a detailed review of choice of law principles, the court concluded that "Delaware and not California has more significant interest" in the dispute and therefore chose to apply Delaware law. In concluding Delaware law should apply, the court noted that 1) the place of incorporation

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is the more significant contact, 2) the company is a Delaware corporation, 3) the two executives are officers of a Delaware corporation, 4) the situs of the company's stock is Delaware, and 5) the shareholders had filed their breach of duty lawsuit in Delaware's Chancery Court for which Delaware law was applied.

The court then determined that, "although it may strain public policy to allow a director to collect insurance on a fraud, it does not appear to be explicitly prohibited by Delaware statutory law." Further, Delaware public policy "does not clearly prohibit Insurers from indemnifying the Insureds' fraud," and accordingly, the court refused to grant the insurers motion for summary judgment "on a claim that indemnification would violate Delaware public policy." The Court noted that no "Delaware decision [] holds that a corporation cannot obtain directors and officers liability insurance that covers breach of loyalty based on fraud."

Arch Ins. Co. v. Murdock, 2018 Del. Super. LEXIS 96 (Del. Super. Ct. 2018).

Excess Insurer not Obligated to Cover Uninsurable Payments Even if Primary Insurers Provided Coverage

The issue in this coverage dispute is whether a second excess insurer's coverage is triggered because of alleged improper erosion by the primary and first excess insurers.

In the claim at issue, the insured settled an ERISA investigation by the Department of Labor ("DOL"), in which the DOL concluded that the insured "was required to restore [] of funds to their rightful source." The insured sought coverage from its fiduciary liability insurers and the primary and first excess insurers provided coverage and contributed to the settlement. The second excess insurer made a payment toward the settlement, but advised the insured that the repayment of funds to the insured's savings plan in accordance with the DOL settlement constituted "uncovered and uninsurable disgorgement" and reserved its rights to seek reimbursement for the portion of the settlement it asserted it did not properly owe.

The second excess insurer then brought a declaratory judgment action against the insured arguing that the insured's settlement payment was uninsurable loss and that it was not compelled to provide coverage despite the primary and first excess insurers' decision to provide coverage. The insured argued that the amount of the settlement that was disgorgement was unclear and, that lack of clarity raises questions regarding whether the payment was uncovered.

The court observed that "it is well established that one may not insure against the risk of being ordered to return money or property that has been wrongfully acquired." The court further noted that "'[w]hen the law requires a wrongdoer to disgorge money or property acquired through a violation of the law, to permit the wrongdoer to transfer the cost of disgorgement to an insurer would eliminate the incentive for obeying the law.'"

The court determined that the DOL consistently referred to the money that the insured was required to pay as "disgorgement" and that "the DOL Settlement falls squarely within the category of uninsurable disgorgement." The court further concluded that the primary insurer's coverage and payment of the DOL settlement was not made pursuant to its obligations under their policy, which does not cover uninsurable loss. Accordingly, the second excess insurer "is not forced to cover uninsurable payments simply because its primary insurers have provided coverage." The court held that the second excess insurer's "payment [] for the DOL Settlement was not covered by its excess coverage policy."

Axis Reins. Co. v. Northrop Grumman Corp., 2018 U.S. Dist. LEXIS 115405 (C.D. Cal. 2018).

Priority of Payments

Court Allows Defense Expense Reimbursement While Company is in Receivership

The United States District Court for the Northern District of Texas allowed the ongoing distribution of Directors & Officers Liability policy proceeds for the advancement of defense expenses for individuals even where all corporate assets were frozen pursuant to a prior court order.

In the underlying case the individual defendants and the company were the subject of an SEC enforcement action. The SEC obtained an order that froze the company assets and appointed a receiver. The individual director defendants moved to lift the automatic stay to allow for the reimbursement of defense expenses that they were incurring defending the claims brought by the SEC. The receiver objected to such reimbursements, arguing that the policy was an asset of the estate and asserted it might bring an action against the directors in the future such that the policy proceeds should be preserved.

The court rejected the receiver's arguments, noting that it had not demonstrated a contractual right to the policy proceeds and had not shown that anything superseded the right of the individuals to payment of their defense expenses as contemplated by the policy. The court took note of the policy's priority of payment provision, which first provided payments for directors and officers individually under the Side A insuring clause.

SEC v. Faulkner, 2018 U.S. Dist. LEXIS 155832 (N.D. Tex. 2018).

Rescission / Application

Ninth Circuit Finds D&O Insurer May Rescind its Policy for Material Misrepresentation

The Ninth Circuit Court of Appeals affirmed a District Court's decision allowing an insurer to rescind its Directors and Officers liability insurance policy based on a material misrepresentation in the insured's application.

Six months before the insured applied for the D&O insurance, FBI agents executed a search warrant at the insured's offices. Over the next several months, investigators subpoenaed

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several of the insured's employees and the insured produced thousands of documents. The insured then applied for D&O insurance and submitted an application that included the following question:

> None of the individuals to be insured under any Coverage Part (the "Insured Persons") have a basis to believe that any wrongful act, event, matter, fact, circumstance, situation, or transaction, might reasonably be expected to result in or be the basis of a future claim? _Yes _No.

The insured answered the question "No" without any disclosure of the FBI raid or the criminal investigation. After the policy was issued, the insured filed a claim. The insurer accepted the claim, but filed an action to rescind the policy when it learned of the pre-application federal investigation. The carrier contended that the insured made a material misrepresentation on its application.

The district court granted the insurer's summary judgment motion for rescission and the insured appealed, asserting that it did not misrepresent the truth because if the application question were read literally, its "No" answer informed the insurer that the insured was aware of circumstances that could lead to a claim.

The appellate court affirmed the district court's decision that the application contained "a material misrepresentation because [the insured] was aware of existing circumstances – the federal investigation – that could lead to a claim." The court noted that, "given the context" of the question, the insurer "reasonably understood [the insured's] answer to mean [the insured] was not aware of any circumstances that could lead to a claim." The court pointed to the application form's instructions, which stated that a "Yes" answer would require the applicant to provide "detailed information" about the answer, which in turn could lead to "substantially different terms and conditions." The insured did not provide any additional information to explain its answer.

The dissent opined that the insured should have prevailed because, as a matter of English grammar, the insured's answer was accurate and the question was "perfectly clear (if inartful)..." The dissenting judge further noted that a "Yes" answer may (but not necessarily) require different policy terms.

Commentators have noted that the insurance application's question, drafted by the insurance company, and the answer created a double negative, and thus, the insured answered the question correctly. Arguably, the insured was not required to provide any additional information to explain its "No" answer, rather, only a "Yes" answer to the question at issue obligated its further response.

Western World Ins. Co. v. Prof'l Collection Consultants, 2018 U.S. App. LEXIS 73 (9th Cir. 2018).

Insurer Entitled to Decline Coverage Due to Material Misrepresentation in Application

The Appellate Division of the Superior Court of New Jersey affirmed summary judgment in favor of an insurer in a legal malpractice insurance coverage case. The coverage dispute revolved around a response in the insured's renewal application for legal malpractice insurance.

The law firm insured responded in the negative to the following query: "[a]fter inquiry, does any firm member know of any circumstance, situation, act, error, or omission that could result in a professional liability claim or suit against the firm or its predecessor firm(s) or any current or former member of the firm or its predecessor firm(s)?" The insurer and the trial court both concluded that a member of the insured law firm had specific knowledge of a potential legal malpractice claim against both the attorney and the firm due to the attorney's prior working relationship with a client that was the subject of legal and regulatory scrutiny. The trial court judge relied on the attorney's deposition testimony from approximately nine months prior to submission of the renewal application. He testified that he was concerned about a claim being asserted against him as an attorney due to the New Jersey Bureau of Securities action against his prior employer and a current client of the law firm.

Despite a purported dispute about whether the attorney's subjective knowledge could be inferred from his prior deposition testimony, the Appellate Division affirmed the lower court's ruling. Following a de novo review of the evidence, the court concluded that the insurer was entitled to decline coverage for the claim based on the material misrepresentation in the renewal application.

Ironshore Indemn., Inc., v. Pappas & Wolf, LLC, 2018 NJ Super. Unpub. LEXIS 1010 (N.J. Super. Ct. App. Div. 2018).

Warranties

Second Circuit Bars Coverage for an SEC Claim Pursuant to a Warranty Statement

This coverage decision focused on whether an insurance claim for an investigation brought by the Securities and Exchange Commission was barred by an exclusion embedded in a warranty statement.

The SEC began its investigation of the insured in December 2009, and continued through July 2011, when the insured's D&O insurance program was up for renewal. As part of the July 2011 renewal, the insured decided to purchase an additional five-million-dollar layer of excess insurance. The new excess carrier required, as part of the additional limit of insurance, that the insured sign a warranty statement that provided "[t]he undersigned, on behalf of [the insured] and all of its directors and officers, hereby represents that as of the date of this letter neither the undersigned nor any other director or officer of [the insured] is aware of any facts or circumstances that would reasonably be expected to result in a Claim under the Captioned Policy. It is understood that the Captioned Policy ... does not provide coverage for Claims relating to facts or circumstances that, as of the date of this letter, [the insured] was aware of and would reasonably have expected to result in a Claim covered by such Captioned Policy..."

The warranty defined the Captioned Policy as the third excess policy. The warranty was signed on August 12, 2011 by the insured's sole officer or director. By then, the SEC had

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issued an Order of Investigation, a subpoena to a former employee, and notice of an impending subpoena to be issued to the insured itself. The insured's outside counsel was aware of these facts when the warranty was signed.

The court held that the warranty statement excluded the insured's losses arising from the SEC Investigation Claim "because contrary to the representations made in the warranty statement, the insured was 'aware' that the SEC had become more—not less—insistent in its demands of the insured…" The insured first countered that the warranty excluded coverage only for Claims relating to facts or circumstances of which the insured's sole officer was aware of the date of the warranty. The officer made sworn statements that she was not aware of the SEC Order of Investigation before August 12, 2011. The court rejected this argument reasoning that the insured's position was unsupported by the text of the warranty, which explicitly referred to facts or circumstances that "[the insured] was aware of." The court explained that because an attorney's knowledge is imputed to her clients under the traditional principles of agency, it must consider the facts and circumstances that were known not only to the sole officer, but also to the insured's outside counsel and in-house counsel. The insured also argued that the phrases "Claim under the Captioned Policy" and "Claim covered by such Captioned Policy" contained within the warranty referred only to Claims giving rise to losses in excess of the underlying existing layers because the third excess policy provided coverage only after the underlying policies were exhausted by a particular Claim.

The court rejected this argument stating that the only reasonable interpretation of the warranty was that it excludes claims arising from facts or circumstances that the insured would reasonably have expected to result in a Claim as defined by the primary policy. According to the court, the same Claims that were "covered by" the primary policy are also covered under the third excess policy given that the excess policy was a "follow-form" policy.

Patriarch Partners, LLC. v. Axis Ins. Co., 2018 U.S. App. LEXIS 34341 (2nd Cir. 2018).

Part IV: Securities and Corporate Governance Cases

United States Supreme Court Decisions

United States Supreme Court Decides *Cyan* Case and Holds that State Courts have Concurrent Jurisdiction over Claims Brought Only Under the 1933 Act.

In a decision that was anxiously anticipated, on March 20, 2018, the United States Supreme Court ruled that state courts have jurisdiction over securities class action lawsuits based only on claims brought under the Securities Act of 1933 ("1933 Act").

Justice Kagan delivered the unanimous opinion of the Court, holding that state courts have concurrent jurisdiction over class action lawsuits that allege only 1933 Act violations, and defendants in such lawsuits may not remove the litigation to federal court.

The 1933 Act was the first Congressional response to the 1929 stock market crash and required companies offering securities to the public to make full and fair disclosures of information. A company's offering documents must contain accurate information so that investors can make informed decisions about their potential purchase. The 1933 Act created a private right of action for investors in an offering and Congress permitted the litigation to be heard in either state or federal court.

Next, Congress enacted the Securities Exchange Act of 1934 ("1934 Act"), which regulated all trading subsequent to the original offering of securities. Cases brought under the1934 Act are subject to the exclusive jurisdiction of the federal courts.

In 1995, Congress passed the Private Securities Litigation Reform Act ("PSLRA") to address perceived abuses of class action litigation against publicly traded companies. The PSLRA amended both the 1933 Act and the 1934 Act; however, important procedural protections were included only for cases filed in federal court, such as the stay of discovery until after a motion to dismiss has been decided. Without the stay, defendants in state court cases could be forced to engage in costly and time-consuming discovery at a much earlier point in time than federal defendants. An unintended consequence of the PSLRA was that litigants began filing state law claims to circumvent procedural requirements that they deemed unfavorable.

Congress addressed this uninteded consequence through the passage of the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"). SLUSA was intended to create uniformity in the treatment of securities class actions. The question presented in Cyan was whether SLUSA eliminated concurrent state and federal court jurisdiction for those lawsuits alleging only 1933 Act claims. Cyan resolved a split between state and federal courts on this issue.

The court analyzed the statutory construction of SLUSA and unanimously held that the text, read "straightforwardly," left state court jurisdiction over 1933 Act claims in place, noting that "SLUSA did nothing to strip state courts of their longstanding jurisdiction to adjudicate class actions alleging only 1933 Act violations. Neither did SLUSA authorize removing such suits from state to federal court."

Cyan, Inc. v Beaver County Employees Retirement Fund, 2018 U.S. LEXIS 1912 (2018).

The United States Supreme Court Clarifies "Whistleblower" for Anti-Retaliation Protections Under Dodd-Frank:

The United States Supreme Court, in Digital Realty Trust, Inc. v. Somers, resolved a circuit split by clarifying who qualifies as a "whistleblower" under the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). In an opinion by Justice Ginsburg, which was either joined or concurred by all the other Justices, the Supreme Court ruled that Dodd-Frank's definition of a "whistleblower" is unambiguous and is limited to individuals who report potential securities law violations to the Securities and Exchange Commission ("SEC"), and does not include individuals who only report internally to their employer.

In Somers, an employee filed a whistleblower anti-retaliation suit under Dodd-Frank, alleging that his employer terminated his

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employment for internally reporting potential securities violations. The employer moved to dismiss the claim on the ground that the employee was not a "whistleblower" because he did not report any alleged securities law violations to the SEC prior to his termination. The district court denied the motion to dismiss and the circuit court of appeals affirmed.

The Court reversed the circuit court and ruled that Dodd-Frank's anti-retaliation provision extends to an individual who reports a violation of securities laws to the SEC, not someone who only reports internally. Unlike the Sarbanes-Oxley Act of 2002, which specifically protects internal reporting at public companies, the Court relied on the unambiguous text of Dodd-Frank which defines "whistleblower" as "any individual who provides...information relating to a violation of the securities laws to the Commission, in a manner established, by rule or regulation, by the Commission." The Court stated that "[w]hen a statute includes an explicit definition, we must follow that definition," even if it varies from a term's ordinary meaning. The Court also stated that the intended purpose of Dodd-Frank was to establish "a new, robust whistleblower program designed to motivate people who know of securities law violations to tell the SEC," which further validated its decision.

The Court declined to give deference to the SEC's Rule 21F-2, which expanded the definition of "whistleblower" under Dodd-Frank's anti-retaliation protections to employees who report internally in a manner protected by Sarbanes-Oxley and ruled "Congress has directly spoken to the precise question at issue" and "[t]he statutes unambiguous whistleblower definition, in short, precludes the Commission from more expansively interpreting that term."

The judgment of the circuit court of appeals was reversed and the case was remanded to the district court for further proceedings consistent with the opinion of the Court.

Digital Realty Trust, Inc. v. Somers, 2018 U.S. LEXIS 1377 (2018).

'33 Securities Act

Texas State Court Dismisses '33 Act Securities Class Action

In this securities fraud class action, the plaintiff asserted claims under Sections 11, 12(a)(2) and 15 of the Securities Act of 1933 (the "33 Act") against the defendants in connection with the defendants' initial public offering. The '33 Act claims were filed in Texas state court. The defendants then removed the '33 Act claims to federal court. The plaintiff responded with a motion to remand the case to state court based on the jurisdictional provisions of the '33 Act. While the plaintiff's motion to remand was pending, the United States Supreme Court issued its ruling in *Cyan, Inc. v. Beaver Cty. Emples. Ret. Fund.,* 2018 U.S. LEXIS 1912 (U.S., 2018), which addressed the jurisdiction of covered class actions that allege only '33 Act claims. The Court held that the clear statutory language did nothing to deprive state courts of their jurisdiction to decide class actions brought under the '33 Act.

Based on Cyan, the federal court remanded the plaintiff's '33 Act claims to Texas state court. However, despite the perceived success by the plaintiff to have his '33 Act claims heard in state court, his claims still faced scrutiny by the state judge. The plaintiff alleged in his state complaint that the company and certain of its directors and officers misled investors in its IPO registration statement and prospectus. The defendants moved to dismiss the plaintiff's state court action arguing that the plaintiff had failed to establish that the alleged misrepresentations were actually misleading. In November 2018, the Texas state court judge granted the defendants' motion to dismiss with prejudice.

Rezko v. XBiotech Inc., Cause No. D-1-GN-17-003063 (Travis Co., Tex. 2018).

Appraisal Rights

Delaware Court Confirms Parent Company's Shareholders not Entitled to Appraisal Rights

The Delaware Court of Chancery recently held that the shareholders of a parent company were not entitled to a statutory right of appraisal of their shares in connection with a "reverse triangular" merger by which the shares of the parent were merged into a newly formed entity that also acquired the shares of the third party involved in the transaction.

The parent company, and a third unrelated entity, announced an agreement to combine the businesses to create a more diversified company. The transaction was structured as a reverse triangular merger by which the third entity would become an indirect, wholly-owned subsidiary of the parent. The parent caused its subsidiary to merge with, and into the third party's indirect owner, resulting in that entity becoming a wholly-owned subsidiary of the parent.

Each share of the subsidiary's common stock would ultimately convert into the right to receive shares of the parent's newly issued common stock. Prior to closing, the third entity's owner would declare a special cash dividend payable to the parent. Once completed, the former equity holders of the third party would own approximately 87% of the parent's new common stock while the original public stockholders of the parent would retain their shares and own approximately 13% of the parent's new common stock.

The parent's stockholders were asked to approve two proposals necessary to effectuate the transactions. First, they were to "vote on a proposal to approve the issuance of...common stock as merger consideration..." and second, to increase number of authorized shares to permit such issuance. In the proxy statement related to these approvals, the parent stated that its stockholders do not have appraisal rights in connection with the transaction. The parent's stockholders then brought suit alleging breach of fiduciary duties by the parent's directors in failing to inform them that they did have appraisal rights, and violations of Delaware General

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Corporation Law ("DGCL") because the proxy failed to inform stockholders of the availability of appraisal rights.

The court determined that the action involved a purely legal question of whether the parent's stockholders were afforded appraisal rights under DGCL and concluded that the stockholders were not entitled to those appraisal rights. DGCL provides that appraisal rights are available for the shares of "a constituent corporation in a merger or consolidation." While noting that the DGCL does not explicitly define "constituent corporation," the court reasoned that various other provisions of the DGCL using the term provided insight into the meaning of the term – and concluded that "constituent corporations" only included entities that actually were merged or combined in a transaction and not the parent of such entities. Additionally, the court analyzed prior case law in which "constituent corporations" was interpreted to mean only those parties actually merging - with one case stating that "stockholders of a parent corporation of a merging subsidiary in a triangular merger 'generally do not have the right to vote on the merger, nor are they entitled to appraisal.'"

Furthermore, the court noted that the stockholders retained their shares in connection with the merger. Under DGCL's "market-out" exception, stockholders of a constituent corporation are not entitled to appraisal rights in a merger if their shares are either listed on a national securities exchange or held of record by more than 2,000 holders. The court noted that the stockholders were not entitled to appraisal rights because the parent's stock was listed on a national securities exchange. The court also recognized that the transaction constituted a sale of control noting that DGCL does not grant appraisal rights simply upon a sale of control, but rather when stockholders' shares are "being taken from them in certain, statutorily specified types of transactions."

City of N. Miami Beach Gen. Emples.' Ret. Plan v. Dr Pepper Snapple Grp., Inc., 2018 Del. Ch. LEXIS 175 (Del Ch. 2018).

Books & Records

Corwin Defense Ruled Inapplicable with Respect to Books & Records Demand

The Court of Chancery of Delaware recently ruled in favor of a stockholder in litigation to compel a response to a Delaware Code Sec. 220 books and records demand. The stockholder had initially served the company with a books and records demand after the majority of the company's stockholders voted to approve a merger. In doing so, the stockholder was seeking to determine whether there had been wrongdoing or mismanagement, and to investigate the independence of the company's directors. The company rejected the demand on the grounds that: (1) the stockholder failed to state a proper purpose for inspection, and (2) the demand was overly broad. The stockholder subsequently filed suit to compel inspection.

In its answer to the stockholder's complaint, the company responded that the inspection was not justified because the stockholder was unable to articulate a credible basis of wrongdoing against the board; a defense set forth in the case *Corwin v. KKR Fin. Hldgs. LLC,* 2015 Del. LEXIS 473 (Del. 2015). In this regard, the company argued that the board acted reasonably in recommending the merger (instead of a more lucrative sale of the parts) and that the disinterested stockholders approved the merger, thereby removing any inference that there was a breach of fiduciary duty. The court, which had not previously addressed the question of whether a Corwin defense could effectively halt a books and records demand, rejected the defense noting that under Delaware law stockholders need not prove wrongdoing or mismanagement in relation to a books and records demand. It ruled that a Corwin defense would be more appropriately raised in subsequent litigation brought by the stockholder. The company was therefore required to produce the books and records for inspection.

Lavin v. West Corp., 2017 Del. Ch. LEXIS 866 (Del. Ch. 2017).

Disclosure Only Settlements

New York Court Refuses to Approve Disclosure-Only Settlement, Finding Disclosures Immaterial to Shareholders

The New York Supreme Court, New York County declined to approve a disclosure-only settlement which the court characterized as a "peppercorn and a fee." Noting that most courts would, until recently, approve such disclosure-only settlements, the court refused to do so, even under the more lenient standard articulated in *Gordon v. Verizon Comm., Inc.* 2017 N.Y. App. Div. LEXIS 740 (NY Sup. Ct. App. Div. 2017) for disclosure-only settlements.

The action involved a shareholder's attempt to enjoin a merger on the grounds of inadequate disclosures. In conjunction with the initiation of the action, which alleged that the company breached its fiduciary duties to its shareholders by making material misstatements and omissions in the proxy, the shareholder moved for a preliminary injunction to enjoin the merger. On the eve of the injunction hearing, the parties settled subject to court approval. The parties entered into a disclosure-only settlement that provided no monetary relief to the stockholders, but required a $500,000 payment in attorneys' fees to plaintiffs' counsel in exchange for a release of the company disclosure violations. The trial court denied the plaintiffs' motion for preliminary approval of the settlement, and, on appeal, the New York Appellate Division – First Department remanded the case, holding that the lower court's ruling was premature and should have awaited a fairness hearing during which opposition from shareholders could be expressed. On remand, the plaintiffs renewed their request for approval of the settlement agreement and the defendants did not oppose. However, shareholders with holdings much larger than plaintiffs' ten shares objected to the settlement, asserting that the additional disclosures were unnecessary and not helpful. The court recognized that no other shareholder supported the settlement, and that larger shareholders of the acquired company "felt that the disclosures in the preliminary and definitive proxies were sufficient to allow it to make an informed decision on the proposed merger."

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The court noted that the standard for approving a class action settlement is a matter of procedural law, and thus applied New York law, rather than the law of the jurisdiction where the defendant corporation was incorporated (North Carolina). Therefore, the court was required to apply the standard to approve disclosure-only settlements set forth by the New York Appellate Division - First Department in Gordon, which requires a review of the following factors: (i) the likelihood of success, (ii) the extent of support from the parties, (iii) the judgment of counsel, (iv) the presence of bargaining in good faith, (v) the nature of the issues of law and fact, (vi) whether the proposed settlement is in the best interests of the putative settlement class as a whole, and (vii) whether the proposed settlement is in the best interest of the corporation.

According to Gordon, the sixth factor (regarding the best interests of the class) is satisfied when the supplemental disclosures provide "some benefit to the shareholders". The standard is less stringent than Delaware's *Trulia* standard, which requires that supplemental disclosures address a "plainly material" misrepresentation or omission for a court to approve a settlement. However, even applying the more liberal Gordon test, the court denied approval of the settlement, concluding that all of the supplemental disclosures were "utterly useless to the shareholders" or of "trivial value."

Delving further into the supplemental disclosures and the reason for its rejection of the settlement, the court found that 1) the additional information that was provided about the rational for the merger was "vague and general in nature"; 2) the publicly available Wall Street research analyst estimates provided was "immaterial" as the proxy does not need to disclose every valuation detail and was of "trivial value given all of the other information disclosed to the shareholders"; and 3) "no reasonable shareholder should care about" the exact positions held by JPMorgan, Deutsche Bank, and Barclays in the acquired company "in deciding whether to vote in favor of the Merger."

Objecting parties must be now careful that such disclosure-only settlements satisfy the Gordon court's "some benefit" standard, which under City Trading Fund v. Nye, the court must plausibly conclude that the disclosures would help a reasonable shareholder decide whether or not to vote for the merger. However, this standard is neither as strict nor as clear as Delaware's "plainly material" standard as articulated in *Trulia*.

City Trading Fund v. Nye, 2018 N.Y. Misc. LEXIS 390 (NY. Sup. Ct. 2018).

Forum Selection

Delaware Rejects Forum Selection as Part of IPO Process

In an effort to limit the impact of the United States Supreme Court's decision in *Cyan, Inc. v. Beaver Cty. Emples. Ret. Fund,* wherein the Court ruled that Section 11 cases of the Securities Act of 1933 could be filed in either state or federal court, a number of companies going public elected to include an exclusive federal court forum selection clause in their registration statements. This was intended to give potential shareholders advance knowledge that any challenge to registration statements would need to be filed in federal court.

The Delaware Chancery Court ruled that such federal forum selection clauses were ineffective. Citing *Boilermakers Local 154 Retirement Fund v. Chevron Corp.,* 73 A.3d 934 (Del. Ch. 2013), the court concluded that the federal forum provisions in registration statements were ineffective. The focus in Boilermakers was whether corporate governance documents were intended to govern the internal affairs of a company. If the focus is internal, wide latitude is given to the company's by-laws. On the other hand, a by-law cannot be used to dictate the forum for a tort or contract claim involving a company, even if such claim is brought by a shareholder.

This decision reaffirms the Delaware Chancery Court's interest in evaluating corporate governance while permitting shareholder plaintiffs to challenge alleged erroneous statements in registration statements in the forum most appropriate to such plaintiffs.

Sciabacucchi v. Salzberg, 2018 Del. Ch. LEXIS 578 (Del. Ch. 2018).

Mergers & Acquisitions

The Ninth Circuit Rules Section 14(e) Claims for Material Misstatements Need Plead Only Negligence, Not Scienter

The United States Court of Appeals for the Ninth Circuit ruled that the first clause of Rule 14(e) of the Securities Act of 1934, which prohibits material misstatements in connection with tender offers, requires only proof of negligence, not scienter. This ruling is significant because five other circuits that considered this question relied on similarities between the first clause of Rule 14(e) and Rule 10b-5(b)[2] and ruled that a scienter requirement applies to Rule 14(e) claims.

The Ninth Circuit explained the bases for its disagreement with the conclusions of the five other circuits as follows: (i) the Supreme Court ruling in *Ernst & Ernst v. Hochfelder,* 42 U.S. 185 (1976) that Rule 10b-5(b) required proof of scienter had nothing to do with the text of the rule itself, but rather the language of Section 10(b), under which Rule 10b-5 was promulgated - "[t]his rationale regarding Rule 10b-5 does not apply to Section 14(e), which is a statute, not an SEC Rule."; (ii) the Supreme Court ruling in *Aaron v. SEC,* 446 U.S. 680 (1980) that Section 17(a)(2) of the Securities Act of 1933—which has nearly identical text as the first clause of Rule 14(e) of the Exchange Act —did not require a showing of scienter and these two provisions both "govern disclosures and statements made in connection with an offer of securities, albeit in different contexts: Section 17(a) applies to initial public offerings while Section 14(e) applies to tender offers" and that "statutes dealing with similar subjects should be interpreted harmoniously"; (iii) the legislative history of the Williams Act, pursuant to which Section 14(e) was enacted, also "supports a negligence standard" because "[t]he legislative history suggests that the Williams Act places more emphasis on the quality of information shareholders receive in a tender offer than on the state of mind harbored by those issuing a tender offer."

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Accordingly, the Ninth Circuit concluded that "because the text of the first clause of Section 14(e) is devoid of any suggestion that scienter is required, ... the first clause of Section 14(e) requires a showing of only negligence, not scienter" and remanded the case to the district court to reconsider defendant's motion to dismiss under a negligence standard.

Because of the conflict amongst the circuits concerning this important question, this specific question may ultimately be answered by the Supreme Court.

Varjabedian v. Emulex Corp, 2018 U.S. App. LEXIS 10000 (9th Cir. 2018).

Florida Adopts Delaware's Strict Trulia Standard for Disclosure Only Merger Objection Settlements

Following a proposed merger agreement between two companies, a shareholder of the acquiree commenced suit for breach of fiduciary duty and failure to disclose relevant information relating to the proposed acquisition. The shareholder, on behalf of a purported class, alleged that the acquiree and its board members engaged in a flawed sales process, agreed to an inadequate sale price, and failed to include in the proxy statement information that was material to the shareholders' decisions on whether to approve the merger. After discovery commenced, the parties reached a settlement. The acquiree was required to provide its shareholders with supplemental disclosures containing information about senior management's potential conflicts of interest, the investment banker's potential conflict of interest, the sales process, and alternatives to merger.

While the settlement approval process was pending before the trial court, another shareholder of the acquiree (a shareholder activist who was also a law school professor) objected to the settlement on several grounds. He contended that the additional disclosures were not material, the released claims had not been adequately investigated by the plaintiffs' counsel, and the plaintiffs' fee request should be rejected because the litigation did not provide a substantial benefit to the shareholders. The trial court ultimately approved the settlement, despite the objection.

On appeal, the Florida appellate court reversed, agreeing with the objector that the trial court had failed to adopt the full Trulia standard. The appellate court conducted a full review of the Trulia decision, noting the increase of disclosure-only settlements and the problems associated with court approval of these kinds of settlements. The appellate court, similar to the Delaware Chancery Court in Trulia, held that "in order for a disclosure settlement to pass muster, the supplemental disclosures must address and correct a plainly material misrepresentation or omission and the subject matter of the proposed release must be narrowly circumscribed to encompass nothing more than disclosure claims and fiduciary duty claims concerning the sale process, if the record shows that such claims have been investigated sufficiently." Having declared Trulia as controlling law in Florida, the appellate court continued, noting that the trial court only applied part of the Trulia standard – the part focusing on the release of claims. Finding that the trial court did not properly analyze the supplemental disclosures that the acquiree provided to shareholders, the appellate court reversed the trial court's approval of the settlement and remanded for the application of the proper Trulia standard.

Griffith v. Quality Distrib., 2018 Fla. App. LEXIS 9879 (Fla. Dist. Ct. App. 2018).

Part V: Other Cases of Interest

Data Security

FTC's Enforcement Action Vacated

The United States Court of Appeals for the Eleventh Circuit vacated an enforcement action brought by the Federal Trade Commission (FTC) against a medical laboratory. The opinion is noteworthy for many reasons, including its highlighting of the role the FTC plays in regulating data security practices.

At issue in this dispute was the FTC's authority to order the laboratory, which previously conducted diagnostic testing for cancer, to implement a comprehensive information security program after the FTC learned that a peer-to-peer file sharing application was installed on a company computer. This file sharing application exposed and provided access to the personally identifiable information of 9,300 consumers including names, dates of birth, social security numbers and other information contained in the lab's data base. A data security firm downloaded the consumer information, and then sought to sell its remediation services to the laboratory. However, when the laboratory ultimately rejected the services of the security firm, the firm delivered the consumer information contained in the file to the FTC. Following its investigation, the FTC issued an administrative complaint against the medical laboratory alleging the laboratory had violated Section 5 of the FTC Act, which provides and declares unlawful "[u]nfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce." It empowers and directs the Commission "to prevent persons, partnerships, or corporations...from using unfair methods of competition in or affecting commerce and unfair or deceptive acts or practices in or affecting commerce."

In reversing the administrative law judge's rulings in favor of the lab, the full Commission determined the lab's "data security practices were unfair under the Act, and that a "substantial injury" occurred because of the

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disclosure of the file. The Commission ordered the lab to install a data-security program that comported with the FTC's standard of reasonableness.

On appeal, the court assumed the lab's failure to better safe guard confidential information was negligent, but stated the "the cease and desist order contains no prohibitions. It does not instruct [the lab] to stop committing a specific act or practice. Rather, it commands it to overhaul and replace its data-security program to meet an indeterminable standard of reasonableness. This command is unenforceable." The court went on to explain the problems that could arise if the Commission sought to enforce the order and engage the district court noting "it would be as if the Commission was [the lab's] chief executive officer and the court was its operating officer. It is self-evident that this micromanaging is beyond the scope of court oversight contemplated by injunction law."

LabMD, Inc. v. FTC, 2018 U.S. App. LEXIS 15229 (11th Cir. 2018).

Employee Classification

California Supreme Court Upholds New Test for Classification of Employees vs. Independent Contractor for California Wage Orders

Several drivers of a delivery service commenced suit against a delivery company, alleging that the drivers were performing the same work after they were reclassified as independent contractors as they were as employees, and, as a result, violated California law. After years of litigation, the California Supreme Court granted review to clarify the appropriate standard for determining whether an individual is an employee or independent contractor for purposes of a wage order. Wage orders regulate employee wages, hours, and working conditions.

The California Supreme Court eliminated the old standards in determining independent contractor status, and implemented a revised test known as the "ABC" test. Under the new "ABC" test, a worker is considered an employee for purposes of a wage order unless the hiring entity establishes each of the three ABC factors: (a) the worker is free from the control and direction of the hirer in connection with the performance of the work, both under the contract for the performance of such work and in fact (b) the worker performs work that is outside the usual course of the hiring entity's business, and (c) the worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed for the hiring entity.

After establishing the revised standard in determining independent contractor status, the California Supreme Court affirmed that a sufficient commonality of interest within the certified class existed to permit the question of whether such drivers were employees or independent contractors for purposes of the wage order to be litigated on a class basis.

Dynamex Operations W. v. Superior Court, 2 018 Cal. LEXIS 3152 (Cal. 2018).

ERISA

Ninth Circuit Rules that ERISA Claims are not Subject to Employee Arbitration Agreement

In a much-anticipated ruling, the United States Court of Appeals for the Ninth Circuit upheld the district court's denial of a plan sponsor's motion to compel arbitration of the plaintiff-employees' ERISA claims. In doing so, however, the court made clear that its decision was based upon "the circumstances presented by this case."

In this matter, eight current and former employees of a university ("Employees") filed a putative class action alleging multiple breaches of fiduciary duty under ERISA 409(a) in administering the university's defined contribution and tax-deferred annuity plans. Each of the plaintiffs had signed an arbitration agreement requiring the arbitration of "all claims that either the Employee or [the university] has against the other party," including any claims for alleged violations of federal law. The district court held that because the Employees were suing on behalf of the plans, the arbitration agreements did not apply.

On appeal, the court initially considered the Federal Arbitration Act (FAA) and the deference it provides to contractual arbitration provisions, noting:

Where there is no conflict between the FAA and the substantive statutory provision, the FAA limits courts' involvement to determining (1) whether a valid agreement to arbitrate exists and, if it does, (2) whether the agreement encompasses the dispute at issue. (internal citations omitted)

The court did not take issue with the validity of the Employees' arbitration agreements. Instead, it focused on whether those agreements extended to the controversy at issue. To that end, the court found that the Employees were actually seeking relief on behalf of the plans (in addition to any relief for themselves) for a breach of fiduciary duty. In that regard, the court reasoned that their claims were analogous to an employee qui tam action which is brought on behalf of the government, even though the employee in that instance "is entitled to receive more than a nominal share of the government's recovery."

The court rejected the university's argument that the Employees were seeking individual relief under a defined contribution plan which, by its very nature, has individual accounts. The court found that the plaintiffs here are seeking (among other financial and equitable remedies):

[the] removal of breaching fiduciaries, a full accounting of Plan losses, reformation of the Plans, and an order regarding appropriate future investments. The relief sought demonstrates that the Employees are bringing their claims to benefit their respective Plans across the board, not just to benefit their own accounts ...

Therefore, the court ruled that the claims in question were not covered by the arbitration agreements because they were not claims an "Employee may have against the University or any of it related entities." *Munro v. Univ. of South California,* 2018 U.S. App. LEXIS 20522 (9th Cir. 2018).

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[Author's note] Of great interest is what the 9th Circuit did not find it necessary to rule upon – namely, the Employees' argument that claims for breach of fiduciary duty under ERISA 409(a) are inarbitrable altogether. In making this argument, the Employees relied upon a 1984 decision from the 9th Circuit itself, which the university contended was irreconcilable with subsequent U.S. Supreme Court case law. In response, the 9th Circuit stated in a footnote that "[a]lthough the Supreme Court has never expressly held that ERISA claims are arbitrable, there is considerable force to [the university's] position." Consequently, the issues of whether ERISA claims may be arbitrated, and whether employee arbitration agreements may be worded to encompass claims for class relief on behalf of plans, remain unresolved.

Fair Labor Standards Act

California Supreme Court Determines that Nontrivial, Regularly Occurring Off-the-Clock Work is Not Subject to the FLSA's De Minimis Rule

The California Supreme Court has determined that the Fair Labor Standards Act's ("FLSA") de minimis doctrine does not bar an employee's California Labor Code claims for unpaid wages.

A coffee shop employee filed a putative class action against his employer under the California Labor Code for unpaid wages. He had performed store closing tasks for roughly 17 months and had been required to clock out every closing shift before initiating certain computer-based closing procedures, activating the store's alarm, and locking the door. He also purportedly walked coworkers to their cars, per company policy, and occasionally reopened the store to allow coworkers to retrieve forgotten items. The unpaid time totaled roughly 12 hours and 50 minutes, equivalent to wages totaling $102.67. The district court found that, despite the regularity of the off-the-clock work, the uncompensated time was de minimis and accordingly granted summary judgment in favor of the employer. On appeal, the Court of Appeals for the Ninth Circuit certified the question for the California Supreme Court, which was tasked with determining whether the FLSA's de minimis doctrine applied to claims for unpaid wages under certain California Labor Code sections. Before deciding in favor of the employee plaintiffs, the court considered: (1) whether California's wage and hour statutes and regulations had adopted the doctrine and (2) regardless of (1), whether the de minimis principle nonetheless applies to wage and hour claims as a matter of state law.

The de minimis doctrine originated from the 1946 United States Supreme Court decision in *Anderson v. Mt. Clemens Pottery Co.* and was codified as a federal regulation in 1961. As stated in *Anderson,* "in recording working time under the FLSA, insubstantial or insignificant periods of time beyond the scheduled working hours, which cannot as a practical administrative matter be precisely recorded for payroll purposes, may be disregarded. The courts have held that such trifles are de minimis." In 1984, the Ninth Circuit in *Lindow v. U.S.* created a three-part test for determining whether otherwise compensable time is de minimis under the FLSA: (1) the practical administrative difficulty of recording the time; (2) the aggregate amount of compensable time; and (3) the regularity of the additional work.

Relative to the instant appeal, the California Supreme Court reviewed the California Labor Code, as well as wage orders adopted by the Industrial Welfare Commission, which take precedence over common law to the extent they conflict. The wage orders defined hours worked as "the time during which an employee is subject to the control of an employer, and includes all the time the employee is suffered or permitted to work..." and otherwise referenced "all hours worked." The court also found that the Labor Code contemplated that employees would be paid for all work performed, which was more protective than the federal rule, which under certain circumstances, "required employees to work as much as 10 minutes a day without compensation." The Court found that neither the Labor Code nor the wage orders showed an intent to incorporate or incorporated a de minimis exception.

The court considered the employer's argument that the de minimis principle was part of the "background of legal principles against which the statutes and wage order have been enacted." The court noted that the Labor Code and wage orders were not concerned only with significant things but also "small things," such as 10-minute rest breaks for nonexempt employees. It considered why the burden should fall on the employee where it is difficult to track and record time worked, especially in an age where technological advances can ameliorate time tracking issues of years past. The court also noted that "a few extra minutes of work each day can add up" and also that the $102.67, while insignificant to the employer, was not de minimis to a person who works for hourly wages; that amount could "pay a utility bill, buy a week of groceries, or cover a month of bus fares." The California Supreme Court ultimately determined that the de minimis doctrine did not apply to bar the plaintiff's claims. It also shifted the burden onto the employer to determine a way to permit tracking of "small amounts of regularly occurring work time."

Troester v. Starbucks Corp., 2018 Cal. LEXIS 5312 (Cal. 2018)

Standing

Ninth Circuit Finds Data Breach Alone is Sufficient for Victims to Establish Standing

The Ninth Circuit Court of Appeals reversed a Nevada U.S. District Court's finding that certain plaintiffs in consumer data breach litigation who had not yet suffered financial harm from identity theft lacked Article III standing. The Ninth Circuit found standing based on the risk of identity theft.

Hackers breached the servers of an online retailer and allegedly stole the personally identifiable information ("PII") of more than 24 million customers including names, account numbers, passwords, email addresses, billing and shipping addresses, telephone numbers, and credit and debit card information. Several of those customers filed class actions lawsuits in federal courts across the country, asserting that the online retailer had not adequately protected their personal information. Some of the plaintiffs alleged that they were harmed by the hacking of their online accounts even though they had not yet suffered any financial loss

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from identity theft caused by the breach. The plaintiffs alleged that the type of information accessed in the breach can be used to commit identity theft, and place them at higher risk of "phishing" and "pharming," which are ways hackers can exploit information they already have obtained to get even more PII. The plaintiffs also specifically alleged that "[a] person whose PII has been obtained and compromised may not see the full extent of identity theft or identity fraud for years." And "it may take some time for the victim to become aware of the theft." The plaintiffs claimed an "imminent" risk of identity theft or fraud from the breach.

The District Court dismissed the claims of those plaintiffs who had not suffered any financial harm on the ground that they lacked Article III standing. To have Article III standing, a plaintiff must show:

> (1) it has suffered an "injury in fact" that is (a) concrete and particularized and (b) actual or imminent, not conjectural or hypothetical; (2) the injury is fairly traceable to the challenged action of the defendant; and (3) it is likely, as opposed to merely speculative, that the injury will be redressed by a favorable decision.

The Ninth Circuit found that those plaintiffs have standing because they sufficiently alleged: 1) an injury in fact based on a substantial risk that the hackers will commit identity fraud or identity theft; 2) that their risk of future harm is "fairly traceable" to the conduct being challenged—the online retailer's failure to prevent the breach; 3) that the injury from the risk of identity theft is also redressable by relief that could be obtained through this litigation (e.g. if plaintiffs succeed on the merits, any proven injury could be compensated through damages and at least some of their requested injunctive relief would limit the extent of the threatened injury by helping plaintiffs to monitor their credit).

This decision is one of a growing number of cases where a court found a data breach alone is sufficient to grant standing to data breach victims.

In re Zappos.com, Inc. Customer Data Sec. Breach Litig., 2018 U.S. App. LEXIS 5841 (9th Cir. 2018).

Seventh Circuit Allows Data Breach Litigation to Continue

The Seventh Circuit Court of Appeals reinstated a data breach class action filed against a retailer. In 2012, the retailer discovered that hackers comprised payment card readers in its stores, resulting in the siphoning-off of customer names, payment card numbers, expiration dates, and PINs. Following the "skimming," the plaintiffs filed a putative class action in March 2013. In September 2013, the district court dismissed the original complaint, holding that the plaintiffs lacked standing as the plaintiffs failed to allege an economic loss connected to the breach.

Following various amendments to the complaint, and various instructive decisions from the Seventh Circuit (see, Remijas v. Neiman Marcus Group, LLC, 794 F.3d 688 (7th Cir. 2015), and Lewert v. P.F.Chang's China Bistro, Inc., 819 F.3d 963 (7th Cir. 2016)), the district court concluded that the plaintiffs' second amended complaint alleged an injury, but failed to adequately plead damages – and dismissed the complaint. On appeal, the Seventh Circuit reversed, finding that the plaintiffs have standing because: the data theft may have led plaintiffs to pay money for credit monitoring services; the plaintiffs may have lost the time value of money even if banks later restore the principal; and the value of one's own time needed to rectify the situation is a loss from an opportunity-cost perspective.

In its analysis, the court noted that, despite the state law claims pled, pleadings are governed by Federal Rule of Civil Procedure 8 and 9. Rule 8(a)(3) requires the plaintiff to identify the remedy sought, but it does not require detail about the nature of the plaintiff's injury. The court also noted that Rule 54(c) entitles a plaintiff to any relief available under law, regardless of whether such relief is pled in a complaint. Further, although Rule 9(g) requires specific allegations about the details of "special damages," neither party alleged that the identified losses were "special damages."

Turning to state law, the court then noted that the California-based plaintiff alleged four kinds of injury: (1) her bank took three days to restore funds someone else had used to make a fraudulent purchase; (2) she had to spend time sorting things out with the police and her bank; (3) she could not make purchases using her compromised account for three days; and (4) she did not receive the benefit of her bargain with the retailer. After dismissing the fourth alleged loss as insufficiently pled, the court recognized the legitimacy of the first three alleged losses – at least in economic terms. The court found that the California plaintiff sufficiently pled "lost money or property" under the relevant California statutes (California's Customer Records Act and its Unfair Competition Law).

Similarly, the court concluded that the Illinois-based plaintiff sufficiently alleged "actual damage" to satisfy the Illinois Consumer Fraud and Deceptive Business Practices Act. In so holding, the court noted that a monthly credit monitoring charge of $17 is a form of "actual damage" – "it is real and measurable; Illinois does not require more."

Despite the finding that the plaintiffs adequately alleged injuries under California and Illinois law, no decision was made by the Seventh Circuit as to whether the retailer violated the state statutes, and the case was remanded. In remanding the action to the district court, the court noted that "[the retailer] was itself a victim," and commented that the plaintiffs may have a "difficult task showing an entitlement to collect damages from a fellow victim of the data thieves." The court continued, noting that state laws do not expressly make retailers liable for failing to "crime-proof" their payment systems, and it was "far from clear" that customers' claims were similar enough to justify a class action.

Dieffenbach v. Barnes & Noble, Inc., 2018 U.S. App. LEXIS 9051 (7th Cir. 2018).

Cyber Corner

First Quarter

SEC Issues Cyber Guidance Aimed at Insider Trading

On February 21, 2018, the United States Securities and Exchange Commission issued a cyber security guidance focusing heavily on disclosure and compliance obligations. It discussed the need for the boards of directors of publicly held companies to implement cyber security procedures and protocols, including those designed to prevent insider trading following cyber incidents.

SEC Chairman Jay Clayton described the guidance as one which "reinforces and expands the SEC's 2011 guidance," and is designed to "promote clearer and more robust disclosure by companies about cybersecurity risks and incidents, resulting in more complete information being available to investors." While not expressly stated, the focus on the avoidance of insider trading appears squarely aimed at the allegations of insider trading in the 2017 Equifax breach. Although most Equifax executives were ultimately cleared of insider trading, the transactions and the organization's delay in disclosure of the breach have raised significant concerns that the SEC has now sought to address.

The guidance emphasizes that cyber disclosure controls and procedures should allow for information about cybersecurity risks and incidents to be efficiently reported to the appropriate levels of an organization, specifically noting that the information should flow "up the corporate ladder." Such reporting is intended to allow senior management to make informed disclosure decisions and certifications. In an effort to facilitate such upward flow of information, the guidance recommends that cybersecurity controls and procedures should provide for an open and robust communication between the technical experts assessing the incident and the disclosure decision makers. The express goal of having technical staff and persons involved in disclosure decisions communicate is a novel recommendation and one designed to bridge what is seen as a common disconnect in post-incident communications.

The avoidance of insider trading, or even the mere appearance of any such insider activity, following a cyber incident is another focal point of the guidance. The suggested courses of action include revisions to an organization's insider trading policies, codes of ethics and codes of conduct in order to specifically reflect cybersecurity and cyber incidents. The SEC also recommends implementation or revision of controls and procedures with respect to opening and closing trading windows to preclude trading for a period of time post-incident.

Lessons Learned: The SEC's February 21, 2018 guidance reflects an increased focus by the SEC on requisite improvements of publicly traded companies' policies, procedures and disclosures related to cybersecurity and incident response. The focus on disclosure requirements and avoiding even the appearance of improper insider trading suggests the SEC was speaking directly to the fallout of the 2017 Equifax breach. Although this latest interpretive guidance reinforces and expands upon the prior 2011 guidance, it is unlikely to be the final suggestion provided by the Commission. Indeed, while the guidance was unanimously approved, two commissioners publicly stated that it did not go as far as it should have to guide public companies. Consequently, and as cyber incidents continue to impact the global economy, further instruction is anticipated.

Second Quarter

GDPR Goes into Effect

Just two years after its enactment, the European Union's ("EU") General Data Protection Regulation ("GDPR") went into effect on May 25, 2018. Although the GDPR has now gone live, many questions remain as to how the regulation will be enforced, as well as uncertainty as to the insurability of fines and penalties across Europe. Despite the uncertainties inherent to the new regulatory framework, risk transfer solutions have emerged to address these exposures.

The GDPR applies to organizations that process the data of EU residents, regardless of whether the data collector does business in, or processes the data within, the EU. In so doing, the GDPR imposes stringent requirements on data collectors, including restrictions limiting collection to that which is needed to fulfill specific, documented purposes. Additionally, the GDPR imposes other types of requirements such as embedded privacy controls, mandatory privacy-risk impact assessments, 72-hour notification requirements, required appointment of a Data Protection Officer and heightened consent requirements.

The fines that may be imposed under GDPR are staggering in their potential: up to 20 million EUR or 4% of an entity's global turnover, if higher. Notably, enforcement of the GDPR, and imposition of its fines and penalties, does not require a breach of security or privacy. This broad regulatory power may give rise to liability which is more expansive that the coverage offered under many privacy or security based insurance policies. Accordingly, careful attention must be paid to whether and when coverage is implicated under a policy where no security or privacy breach occurs, but the insured was merely non-compliant. Beyond the threshold issue of the insurance trigger, there remains much uncertainty as to whether the fines and penalties are insurable under the laws of the various EU member nations.

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The GDPR also allows citizens to bring private actions for damages, including collective actions that are similar, though not identical, to the class action process provided by the United States legal systems. As a result, coverage for defense costs and fees incurred for third-party claims and regulatory actions take on significant importance.

Lessons Learned: Although the GDPR has brought comprehensive, sweeping privacy and security mandates to data collectors and data processors, much is still to be determined and learned as enforcement of the regulation proceeds over time. While questions regarding the insurability of fines and penalties throughout Europe remain open, Aon is working to address these emerging and increased exposures through careful review of policy forms and working to provide beneficial clarifications to policy wording and endorsements.

Third Quarter

California Enacts Sweeping Cyber Laws

Within a three-month window the state of California has enacted two groundbreaking cyber laws that bring significant changes in consumer protection.

On June 28, 2018, Governor Jerry Brown signed into law the Consumer Privacy Act of 2018 (the "Act") after the bill was introduced in the California Legislature only a few days earlier. The Act was quickly passed and signed into law to prevent a similar consumer-protection based ballot initiative from appearing on the November 2018 general election ballot. Despite the hasty enactment, the Act does not go into effect until January 2020.

The Act has been compared to GDPR in its scope, and insofar as it grants consumers certain rights regarding their personal information, the comparison is valid and represents the first legislation of its kind in the United States. Among the rights granted by the Act are the right to know what personal information a business has collected about them, with additional details regarding the sourcing, use, and disclosure being available upon request. Additionally, the Act grants consumers the right to "opt out" of allowing their personal information to be sold to third parties, as well as the "right to be forgotten" or have a data holder delete the individual's personal information.

In addition to these consumer rights, the Act also places obligations on the data holders, including public disclosures to consumers through privacy policies or, if not through a public privacy policy, otherwise at the time the personal data is collected. Among the required disclosures are the categories of and purposes for which personal information is collected, as well as disclosure of the categories of personal information that the data holder has sold or disclosed in the preceding 12 months.

Like GDPR, the Act applies to companies that collect data of California residents, even if the data collector is not incorporated nor has a place of business in California. In fact, compliance is exempted only "if every aspect of ... commercial conduct takes place wholly outside of California," which would require that the data of the consumer be collected while that individual was outside of California. Unlike GDPR, the Act does not mandate data security protocols or requirements.

Enforcement of the Act may be carried out by the California Attorney General, with civil penalties for intentional violations of the Act of up to $7,500 per violation. The Act also provides an express private right of action in which statutory or actual damages and injunctive and other relief may be sought. Such private rights of action may be brought by an individual or through a class action. There are, however, certain prerequisites for a putative plaintiff to satisfy prior to bringing suit, including thirty days' notice of intent to sue if statutory damages are sought. The data collector has a 30-day period in which to demonstrate that the violation has been cured and will not occur in the future.

While similar, compliance with the GDPR does not ensure compliance with the Act. Most notably, unlike the GDPR, the Act does not require companies to obtain user consent to their processing of consumers' personal information. Succinctly stated, GDPR's consent requirement functions as an "opt-in" while the Act assumes consent unless the consumer "opts out." This difference may require companies subject to both laws to utilize both opt-in and opt-out options to sell data in compliance with both laws.

In late September, California became the first state in the U.S. to pass an internet of things (IoT) cybersecurity law when Governor Brown signed Bill SB-327 into law. The law, like the Act, is aimed at protecting consumers of smart home devices against possible privacy risks and also does not go into effect until January 1, 2020.

Continues

The IoT law expressly requires manufacturers of IoT devices to provide "reasonable security features" designed to protect user privacy. Although what are "reasonable security features" may be subject to debate, the law has attempted to provide some clarity. For example, if a connected device is subject to authentication outside a local area network, the law provides that either a unique pre-programmed password or the device requiring a user-generated new means of authentication prior to initial access being granted would meet the reasonable standard.

Nevertheless, questions remain as to whether these protections are a floor or a ceiling in terms of reasonable security features, and many questions remain as to the impact of this IoT law, which is the first of its kind in the United States, despite similarly-scoped bills having been introduced in Congress.

Lessons Learned: California's groundbreaking laws have the potential to dramatically impact privacy law, and technological innovation and development throughout the United States. Like GDPR, the Consumer Privacy Act has application to businesses that are not domiciled in California, but nevertheless collect and maintain data and personal information of California residents. As was the case with GDPR preparation, companies that are subject to the Act will need to act to ensure compliance with the law's mandates before January 1, 2020. Likewise, the IoT law requires manufacturers to meet specific standards of security which, in addition to compliance costs, may stifle innovation as manufacturers determine whether emerging technology meets the legal mandates. Both laws will require that companies subject to their requirements ensure that their cyber and professional liability policies will respond to the enhanced regulatory actions that are certain to follow, as well as the private right of action expressly provided under the Act.

Fourth Quarter

Mondelez Sues Property Insurer for Denial of NotPetya Business Interruption Losses

In October 2018, food manufacturer Mondelez International sued its property insurance company in Illinois state court following its denial of losses resulting from the June 27, 2017, NotPetya attacks. Although the litigation will be closely monitored for its impact on the coverage available for non-physical damage under property policies, it is likely not as significant in connection with stand-alone cyber insurance programs given the language differences contained in many cyber policies.

The NotPetya attacks marked the first significant event resulting in widespread and substantial operational losses to manufacturers worldwide. In the case of Mondelez, the attack caused damage to over 1700 servers and 24,000 laptops, resulting in claimed losses exceeding $100 million. Zurich sold Mondelez an all-risk property policy under which Mondelez timely provided notice and submission of the claim. On June 1, 2018, Zurich sent a denial letter in connection with the claim, asserting an exclusion in the policy for losses caused by "a hostile or warlike action in time of peace or war, including action in hindering, combating or defending against an actual, impending or expected attack by any: (i) government or sovereign power (de jure or de facto); (ii) military, naval or air force; or (iii) agent or authority of any party specified in (i) or (ii) above." Although it is unclear from the pleading what facts or information supported the application of this exclusion, the NotPetya attacks have been reportedly attributed to Russian hackers.

Zurich rescinded the denial, yet never made any payments despite a requested advance. After no progress was made on the claim and no payment was made on the requested advance, Mondelez indicated it would file suit given the delay, and the insurer subsequently reasserted its denial based on the war exclusion, as well as additional coverage defenses not raised in the initial denial. Mondelez sued, alleging claims for breach of contract and promissory estoppel, as well as a count for unreasonable and vexatious conduct pursuant to Illinois statute.

Lessons Learned: The Mondelez litigation may impact how insureds choose to transfer cyber risk in the future, particularly if the war/state-sponsored act exclusion is upheld in a court ruling in what is believed to be the first instance of a "warlike action" exclusion being asserted for a cyber attack, or in a case with no armed conflict or similar act. In such a scenario, insureds likely would not see the same value in coverage for non-physical damage to electronic media and software under a property policy, but instead seek to move the entire risk into a cyber program. However, it is important to keep in mind that this case is about coverage for business interruption from a cyber attack under a property policy, and not a stand-alone cyber policy. Media reports have noted the lawsuit but failed to provide critical specificity around the very important fact that the denial was in connection with a property policy and not a stand-alone cyber policy. The property policy did not contain wording carving back coverage for cyberterrorism. This type of carveback is found in many cyber policies and may be the key difference between a covered claim and a denial.

SEC Filings

source: www.sec.gov/litigation.shtml

First Quarter

In January 2018, the SEC charged David S. Haddad and two of his companies, **Trafalgar Square Risk Management, LLC and New England RE, LLC,** with fraud. The SEC settled the charges.

In March 2018, the SEC charged **Theranos Inc.**, its founder and CEO Elizabeth Holmes, and its former President Ramesh Balwani with fraud. The charges have since been settled.

In March 2018, the SEC charged Jun Ying, a former CIO of a U.S. business unit of **Equifax**, with insider trading in connection with the company's 2017 data breach. The SEC seeks disgorgement, penalties and injunctive relief against Ying.

Second Quarter

In April 2018, the SEC charged Frank Reynolds, CEO of a biotech startup, **PixarBio Corp.**, and others with fraud. The complaint seeks injunctive relief, return of ill-gotten gains with interest, penalties, and industry and penny stock bars.

Third Quarter

In August 2018, the SEC announced fraud charges against **Constant Contact Inc.'s** CFO Harpreet Grewal. The SEC seeks a permanent injunction, disgorgement, interest, civil monetary penalties, and a director and officer bar.

Fourth Quarter

In November 2018, the SEC filed charges for violations of the registration provisions of the federal securities laws against **1pool Ltd.** a/k/a/ 1Broker and its CEO Patrick Brunner. The SEC seeks permanent injunctions, disgorgement, interest, and penalties. In a parallel action, the Commodity Futures Trading Commission announced charges against 1Broker arising from similar conduct.

SEC Settlements and Judgments

source: www.sec.gov/litigation.shtml

First Quarter

In January 2018, the SEC entered consent judgments in a fraud case brought by the SEC against Richard Harmon and John Kaptrosky, the respective former Chairman/CEO and COO of **The Ticket Reserve Inc.** Harmon was ordered to pay $945,078 in disgorgement and prejudgment interest, plus a $325,000 civil penalty. Monetary remedies against Kaptrosky are to be determined. Both individuals also consented to being enjoined from violating certain securities laws.

In January 2018, the SEC settled charges against David S. Haddad, **Trafalgar Square Risk Management, LLC** and **New England RE, LLC.** Without admitting or denying the allegations, the defendants consented to final judgments enjoining them from violating the securities laws. Haddad and Trafalgar also agreed to pay $619,382.43 in disgorgement plus prejudgment interest of $25,131.83. Haddad and New England Re agreed to pay $269,080 in disgorgement plus prejudgment interest of $2592.66. Haddad also agreed to pay a penalty of $181,071 and consented to additional injunctive relief and an officer and director bar.

In February 2018, the SEC entered final judgment against Robert Walton, Jr., former President of **Hadsell Chemical Processing, LLC.** Walton was ordered to pay $506,471 in disgorgement, $51,183 in prejudgment interest, and a civil monetary penalty of $506,471. He was also enjoined from future violations of the securities laws.

In February 2018, the SEC settled insider trading charges against Todd M. LaVelle, the former CEO and board member of **In Home Medical Solutions, LLC,** and Ara Chackerian, its former officer and board member. LaVelle agreed to entry of a judgment enjoining him from violating certain securities laws and ordering him to pay roughly $53,000 in disgorgement, prejudgment interest and civil penalties. Chackerian consented to a cease and desist order and agreed to pay over $330,000 in disgorgement, prejudgment interest, and civil penalties.

In February 2018, the SEC entered final judgment against Brian S. Block, the former CFO of **American Realty Capital Properties,** on accounting fraud charges. Block consented to entry of the final judgment, which imposed injunctive relief, a $160,000 civil penalty, and a permanent officer and director bar, in addition to a suspension from practicing before the SEC as an accountant.

In February 2018, a consent judgment was entered against **AVEO's** former Chief Medical Officer, William Slichenmeyer. Slichenmeyer was ordered to pay disgorgement and prejudgment interest totaling $2,835.54 and a civil penalty of $50,000. He was also enjoined from future securities law violations. The court previously entered judgment against AVEO and its former CEO, Tuan Ha-Ngoc. Litigation against former CFO David Johnston is ongoing.

In March 2018, the SEC announced that it settled charges against **Theranos Inc.** and its founder and CEO Elizabeth Holmes. Holmes agreed to pay a $500,000 penalty, a 10 year director and officer bar, return of 18.9 million shares obtained during the fraud period, and relinquishment in voting control.

In March 2018, the SEC announced that it obtained a final judgment against **Revolutions Medical Corporation** and its former CEO, Ronald L. Wheet with respect to fraud allegations filed in 2012. The company and Wheet were ordered to respectively pay civil penalties of $2.325 million and $465,000, and to jointly and severally pay disgorgement of $115,000. Both are enjoined from violating certain securities laws.

In March 2018, the SEC announced a final judgment against Howard B. Present, the co-founder and former CEO of **F-Squared Investments.** The court entered final judgment against Present, enjoining him from violating certain provisions of the Investment Advisers Act. He was also ordered to disgorge $10.8 million, pay interest of $1.38 million and pay a $1.575 million penalty.

In March 2018, the SEC announced that it settled a civil action against **Akorn, Inc.**, its former CFO, Timothy Dick, and its former Controller, David Hebeda. Without admitting or denying the charges, Akorn consented to entry of an order permanently enjoining it from violating certain provisions of the Exchange Act. Dick and Hebeda similarly consented to entry of orders permanently enjoining them from controlling people liable for violations of certain provisions of the Exchange Act and imposing a $20,000 civil penalty on each of them.

Second Quarter

In April 2018, the SEC announced that it obtained judgment against Stephen DiCarmine and Joel Sanders, the Executive Director and former CFO of **Dewey & LeBoeuf**. Each consented to entry of judgment respectively enjoining them from violating certain securities laws. Sanders is ordered to pay disgorgement, interest and penalties to be determined at a later date. He is also prohibited from acting as a director or officer of a public company. DiCarmine was ordered to pay a civil monetary penalty of $35,000.

In May 2018, the SEC filed and settled fraud charges against Steven L. Down, CEO of **The Falls Event Center**. Without admitting or denying the allegations, the Falls Event Center and Down consented to entry of a final judgment enjoining them from violating certain sections of the securities laws. Down also agreed to a civil penalty of $150,000.

In May 2018, the SEC charged Aaron Stanz, CEO of **Bud Genius Inc.** with fraud and settled those charges. Without admitting or denying the allegations, Stanz agreed to judgment enjoining him from violating certain securities laws, imposition of five-year director and officer and penny stock bars, and payment of disgorgement and interest totaling $158,829. The company also agreed to judgment enjoining it from violations of certain securities laws.

In June 2018, the SEC charged Stephen B. Pence, the former chairman of **General Employment Enterprises**, with fraud and then settled those charges. Without admitting or denying the allegations, Pence consented to a permanent injunction from violating certain securities laws, payment of a $200,000 civil penalty, and a permanent bar from serving as a director or officer of a public company.

Third Quarter

In June 2018, the SEC announced accounting fraud charges against **Axessteel, Inc.**, its CFO Patrick J. Gray, its former CEO Harold Clark Hickock III, and Steven R. Sabin. Axessteel, Gray, Hickock, and Sabin agreed to settle without admitting or denying the allegations and consented to entry of a final judgment that enjoins them from violating certain securities laws. Gray, Hickock and Sabin were ordered, respectively, to pay penalties of $40,000, $25,000, and $10,000. Hickock consented to a permanent public director and officer bar and Gray consented to a five-year public director and officer bar.

In July 2018, the SEC announced fraud charges against **United Development Funding III, LP, United Development Funding IV**, and executives Hollis M. Greenlaw, Benjamin L. Wissink, Theodore F. Etter, Cara D. Obert, and David A. Hanson. Without admitting or denying the SEC's allegations, Greenlaw, Wissink, Etter, and Obert agreed to pay $8.2 million in disgorgement, prejudgment interest, and civil penalties. Hanson agreed to pay a $75,000 civil penalty. The individuals also agreed to be permanently enjoined from violating certain provisions of the securities laws.

In July 2018, the SEC announced settlements involving Kevin Modany and Daniel Fitzpatrick, the former CEO and CFO of **ITT Educational Services, Inc.** The court imposed a five-year director and officer bar, ordered Modany and Fitzpatrick to pay penalties of $200,000 and $100,000, respectively, and enjoined them from violating certain provisions of the securities laws. Modany and Fitzpatrick also agreed to suspensions from appearing and practicing before the SEC as accountants.

In July 2018, the SEC announced fraud charges against Stephen J. Barber and Lee Larry Arrowood, the former CEO and President of **Oakridge Global Energy Solutions, Inc.** Without admitting or denying the SEC's allegations, Arrowood consented to be permanently enjoined from future violations of the Exchange Act, a public director and officer bar and to pay a civil penalty of $50,000. The litigation continues against Barber.

In July 2018, the SEC announced fraud charges against **Centor Energy, Inc.** and its CEO Frederick DaSilva. Without admitting or denying the allegations, both consented to a final judgment enjoining them from violating certain provisions of the Securities Exchange Act. DaSilva also agreed to pay disgorgement of $7,500, prejudgment interest of $1,028, and a civil penalty of $22,500. He further agreed to imposition of penny stock and director and officer bars.

In July 2018, the SEC announced that it settled charges against Dhru Desai, the former CFO of **Quadrant 4 System Corp**, and Bhushan Dandawate, who allegedly aided and abetted the fraudulent scheme. Dandawate agreed to a consent judgment permanently enjoining him from future securities laws violations, imposing a permanent director and officer bar, and requiring him to pay disgorgement and interest totaling $131,466 and a civil penalty of $325,000. Desai consented to a judgment imposing a permanent director and officer bar, and requiring payment of $1.29 million plus a $184,767 penalty. Desai is also permanently enjoined from violating certain securities laws. The SEC action against the former CEO continues.

In September 2018, the SEC announced that it filed and settled fraud charges against **Tangoe, Inc.**, its former CEO Albert R. Subbloie, its former CFO Gary R. Martino, its former VP of Finance Thomas H. Beach and its former SVP of Expense Management Operations Donald J. Farias. Tangoe, Subbloie, Martino, and Beach agreed to settle the SEC charges without admitting or denying the allegations. They agreed to pay respective penalties of $100,000, $50,000, and $20,000.

In September 2018, the SEC charged and settled fraud charges against Adam C. Wasserman, the former CFO of a public company based in China. Without admitting or denying the allegations, Wasserman agreed to entry of final judgment permanently enjoining him from violating certain provisions of the securities acts, requiring him to pay a $20,000 civil penalty, and barring him from serving as a public company director or officer for five years.

In September 2018, the SEC charged and settled fraud charges against **SeaWorld Entertainment Inc.**, its former CEO James Atchison and its former VP of Communications Frederick D. Jacobs. Without admitting or denying the allegations, SeaWorld agreed to pay a $4 million penalty and Atchison agreed to pay $850,183 in disgorgement and prejudgment interest and a $150,000 civil penalty. Jacobs agreed to pay disgorgement and prejudgment interest of $99,155.

In September 2018, the SEC announced that it settled fraud charges against **Clovis Oncology Inc.**, its CEO Patrick Mahaffy, and its former CFO Erle Mast. Without admitting or denying liability, Clovis agreed to pay a $20 million penalty, and Mahaffy agreed to pay a $250,00 penalty. Mast agreed to pay a $100,000 penalty and to pay disgorgement and prejudgment interest of $454,145.

In September 2018, the SEC announced that it charged and settled fraud charges against **Sientra, Inc.** and its former CEO, Hani Zeinl. Without admitting or denying the allegations, Sientra agreed to cease and desist from future violations of certain securities laws. The SEC had given strong consideration to Sientra's prompt action, self-reporting to the SEC, and extensive cooperation. The litigation against Zeinl continues.

In September 2018, the SEC announced that it filed and settled accounting fraud charges against **Barrett Business Services, Inc.** and its former CFO James D. Miller, as well as books and records violations against the company's former Controller, Mark Cannon. Without admitting or denying the allegations, BBSI agreed to pay a $1.5 million penalty and Cannon agreed to pay a $20,000 civil penalty and to an accounting suspension. The litigation against Miller continues.

In September 2018, the SEC announced that it settled fraud charges involving John, Jason, Derek and Jered Galanis, as well as Gary T. Hirst (the former CEO and President of **Gerova Financial Group, Ltd.**), and an investment advisor named Gary Hamels. As part of the settlement, each of the individuals consented to be permanently enjoined from violating certain securities laws. Jason Galanis and Hirst were also permanently barred from serving as a director or officer of a registered issuer. Jared Galanis was ordered to pay disgorgement of $207,500 and prejudgment interest of $37,699. He was also suspended from practicing before the commission. Disgorgement was deemed satisfied by restitution ordered to be paid in a parallel action brought by the US Attorney's Office in the Southern District of New York.

Fourth Quarter

In October 2018, the SEC charged **Salix Pharmaceuticals, Ltd.** and its former CFO, Adam Derbyshire. Without admitting or denying the allegations, Salix agreed to be enjoined from future violations of the Securities and Exchange Acts. Derbyshire also agreed to a permanent injunction from violating the Acts. He further agreed to pay $558,534 in disgorgement and interest plus a penalty of $494,836 and agreed to a five-year officer and director bar. Derbyshire also agreed to a suspension from practicing before the SEC as an accountant, subject to reinstatement after five years.

In October 2018, the SEC filed fraud charges against **Bebida Beverage Co.** and its former CEO and President Brain Weber. Without admitting or denying the allegations, Weber consented to entry of a final judgment permanently enjoining him from similar future violations and ordering him to pay $208,000 in disgorgement, $23,436 in prejudgment interest, and $160,000 in civil penalties. Weber also agreed to a permanent officer and director bar and a penny stock bar.

In November 2018, the SEC settled charges against the former CEO and CFO of a now-defunct disaster remediation and construction business, **Home Solutions of America, Inc.** The former CEO, Frank J. Fradella, agreed to pay $1 million in disgorgement, a permanent officer and director bar, and permanent injunction from violating or aiding and abetting violations of provisions of the Securities and Exchange Acts. Former CFO, Jeffrey M. Mattich, agreed to disgorge $86,620 and to pay a civil penalty of $50,000. He also agreed to be permanently prohibited from violating sections of the Securities and Exchange Acts.

In November 2018, the SEC charged **Giga Entertainment Media Inc.** and five of its former directors and officers—Gary Nerlinger, Jarret Streiner, Lawrence Silver, Alfred Colucci, and Charles Noska—with fraud. Without admitting or denying the allegations, the five consented to the SEC's entry of an order finding violations of the antifraud provisions and registration provisions of the securities laws. Colucci and Noska each agreed to pay a $25,000 penalty and Streiner agreed to pay a $15,000 penalty. Nerlinger, Silver and Colucci each also agreed to permanent director and officer bars and Streiner agreed to a five-year bar. The court is yet to determine Silver's penalty and the amount of Nerlinger's disgorgement and penalty.

In November 2018, the SEC announced that it resolved multiple actions against Dhru Desai, the CFO of **Quadrant 4 System Corp.** Desai was ordered in the SEC's civil action to pay $1.63 million in disgorgement, prejudgment interest, and a civil penalty. He was also suspended from practicing before the SEC based on his guilty plea in a parallel criminal action and sentenced to 39 years in prison in the criminal action.

In November 2018, the SEC entered final judgment against Steven A. Newman, a former executive of **Xybernaut Corp.** The final judgment enjoins Newman from violating provisions of the Securities and Exchange Acts and bars him from acting as an officer or director of a public company. He is also required to disgorge $429,100 in ill-gotten gains, which was deemed satisfied by restitution paid in a parallel criminal action.

In December 2018, the SEC obtained judgment against the CEO of **GTS Inc.**, John T. Place. Place consented to judgment without admitting or denying the allegations. The judgment permanently enjoins him from violating sections of the Exchange Act. He is also barred from the securities industry. The amount of any penalty or disgorgement will be determined at a later date.

In December 2018, the SEC obtained final judgment against Gregory E. Webb, the Chairman and CEO of **InfrAegis, Inc.** Webb consented to entry of a judgment enjoining him from violating provisions of the Securities Act and the Exchange Act and requiring disgorgement of $550,057 and payment of $132,352 in prejudgment interest. The payments were deemed satisfied by a previous order to pay $9 million in a criminal action.

FCPA Enforcement Actions

source: www.sec.gov/litigation.shtml

First Quarter

In March 2018, the SEC announced that it resolved FCPA charges involving **Elbit Imaging Ltd.** Elbit and one of its subsidiaries had allegedly paid millions of dollars to third party offshore consultants and sales agents in conjunction with a Romanian real estate development project. The SEC alleged the companies failed to maintain sufficient internal accounting controls and failed to properly maintain books and records. Without admitting or denying the charges, Elbit agreed to a cease-and-desist order and agreed to pay a $500,000 civil penalty.

In March 2018, the SEC announced it resolved FCPA charges involving **Kinross Gold Corporation**. It was alleged that Kinross delayed implementation of anti-corruption controls after the $7.1 billion acquisition of subsidiaries in Africa and then failed to maintain such controls. The SEC cited several transactions involving Mauritanian government officials that ran afoul of the FCPA. Without admitting or denying the charges, Kinross agreed to a cease-and-desist order and agreed to pay a $950,000 civil penalty. The company is also required to report for one year on all remedial steps it takes.

Second Quarter

In April 2018, the SEC announced that it resolved FCPA violations involving **The Dun & Bradstreet Corporation**. The SEC had alleged that that unlawful payments were made by third-party agents of two Chinese subsidiaries in order to secure data vital to D&B's business. Without admitting or denying the allegations, D&B agreed to pay disgorgement of $6,077,820, prejudgment interest of $1,143,664, and a civil penalty of $2 million.

In April 2018, the SEC announced that it resolved FCPA violations involving **Panasonic Avionics Corporation**. The SEC had alleged that PAC offered a lucrative consulting position to a government official in order to help PAC obtain business. The position paid $875,000 and required little to no work. The SEC also found that PAC fraudulently overstated pre-tax and net income by prematurely recognizing revenue. PAC consented to an order finding it violated anti-bribery, anti-fraud, books and records, internal accounting controls, and reporting provisions of the Securities Exchange Act of 1934, and ordering it to pay $137 million as part of a deferred prosecution agreement.

Third Quarter

In In July 2018, the SEC announced that **Credit Suisse Group AG** agreed to resolve charges that it violated the FCPA. The SEC found that Credit Suisse hired more than 100 individuals in the Asia-Pacific region in exchange for business revenue. Credit Suisse agreed to pay disgorgement of $24.9 million plus $4.8 million in interest. Credit Suisse also agreed to pay a $47 million criminal penalty to the U.S. Department of Justice.

In August 2018, the SEC announced that **Legg Mason Inc.** agreed to resolve SEC charges that the company violated the FCPA. According the SEC's order, the Company's former subsidiary partnered with a French financial services company to solicit business from Libyan state-owned financial institutions in exchange for business. Legg Mason agreed to disgorge $27.6 million plus pay $5.9 million in prejudgment interest to settle internal accounting control violations.

In September 2018, the SEC announced that **Sanofi** agreed to resolve charges of FCPA violations. According to the SEC, Sanofi distributors were used as part of a kickback scheme that generated funds to pay bribes to local officials in Kazakhstan to ensure Sanofi was awarded tenders at public institutions. Sanofi agreed to a cease and desist order, to pay $17.5 million in disgorgement, $2.7 million in prejudgment interest, and a civil penalty of $5 million to settle books and records and internal accounting violations.

Continues

In September 2018, the SEC announced settled FCPA charges against a New Jersey real estate broker, **Joohyun Bahn** on behalf of **Colliers International Group, Inc.** According to the SEC, Bahn had attempted to bribe a foreign official in the Middle East in order to broker the sale of a high-rise condo building in Vietnam on behalf of Colliers. Bahn agreed to pay $225,000 in disgorgement, which was deemed satisfied by forfeiture and restitution ordered in a related criminal proceeding.

In September 2018, the SEC announced that it resolved FCPA charges involving **United Technology Corporation**. According to the SEC, United Technology's subsidiary, Otis Elevator Co., made unlawful payments to Azerbaijani officials to facilitate sales in Baku and as part of a kickback scheme in China. United Technology agreed to pay disgorgement of $9,067,142 plus interest of $919,392, and a penalty of $4 million to settle violations of books and records, anti-bribery, and internal accounting controls provisions.

In September 2018, the SEC announced that it resolved FCPA charges involving **Sociedad Quimica y Minera de Chile, S.A.** According to the SEC, SQM's former CEO, Patricio Contesse Gonzalez, caused SQM to make improper payments to Chilean political figures and their associates. The settlement requires SQM to pay $125,000 to resolve the charges.

In September 2018, the SEC announced that it resolved FCPA charges involving **Petroleo Brasileiro S.A.** ("Petrobas"). According to the SEC, Petrobas' senior executives worked with the company's largest contractors to inflate the cost of infrastructure projects by billions of dollars and that the company's contractors paid billions in kickbacks to the executives who shared the same with Brazilian politicians. The U.S. Department of Justice entered into a non-prosecution agreement. In connection with the SEC charges, Petrobas agreed to pay $933 million in disgorgement and prejudgment interest and a $853 million penalty, subject to offsets for payments made to investors in a related class action settlement and penalties paid to Brazilian law enforcement.

In September 2018, the SEC announced that it resolved FCPA charges involving **Stryker Corporation**. According to the SEC, Stryker failed to maintain appropriate books and records and had improper accounting controls to detect improper payments in connection with the sale of the company's products in India, China, and Kuwait. Stryker consented to a cease and desist order and agreed to pay a $7.8 million penalty.

Fourth Quarter

In November 2018, the SEC announced that **Vantage Drilling International** ("Vantage") agreed to settle FCPA charges involving its predecessor, Vantage Drilling Company ("VDC"). The charges related to a bribery scheme in Brazil whereby a director and marketing agent paid bribes to officials at a Brazilian state-owned oil and gas company in order to obtain a lengthy drilling services contract. Without admitting or denying SEC findings that VDC violated the internal controls provisions, Vantage agreed to paid $5 million in disgorgement.

Index

Cases of Interest

Index

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