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I. Burlington Ins. Co. v. N.Y.C. Transit Auth. and it’s impact.

As many insurance attorneys are aware, the additional insured provision typically contained in a commercial general liability policy triggers coverage for an additional insured where the “bodily injury” or “property damage” was either “caused by” or “arising out of” the acts or omissions, or alternatively the work of the named insured. This endorsement typically applies to property owners who have entered into construction agreements wherein the contractor agreed to defend and indemnify the premises owner, and injury or damage subsequently ensues during construction. Historically, New York Courts saw “caused by” and “arising out of” as interchangeable. For several years insurance attorney practitioners relied upon W&W Glass Systems, Inc. v. Admiral Ins. Co. for the proposition that “caused by” does not materially differ from the phrase “arising out of.” 937 N.Y.S.2d 28 (1st Dep’t 2012). Thus both phrases received the same analysis: originating from, incident to, or having connection with; it requires only that there be some causal relationship between the injury and the risk for which coverage is provided. Regal Const. Corp. v. Nat’l Union Fire Ins. Co. of Pittsburgh, PA, 15 N.Y.3d 24 (2010).

In 2017, the Court of Appeals rocked the New York insurance industry with the Burlington Ins. Co. v. N.Y.C. Transit Auth. decision, finding that “caused by” and "arising out of" terminology contained in an additional insured form in a standard CGL policy are no longer treated as interchangeable. 29 N.Y.3d 313 (2017). Instead, the Court determined that in order to determine if a loss was "caused by" the acts or omissions of the named insured, the Court of Appeals now requires a finding of proximate causation assigned to the named insured. This created multiple new questions that are slowly being answered by the lower courts:

(1) How does this affect cases regarding injuries to a named insured’s employee?

In the past, New York cases dictated that where the loss in question involves the named insureds employee, coverage is all but automatically triggered, regardless of the wording "caused by" or "arising out of." It was not clear if Burlington changed this fact, as the injury in question in Burlington did not include a named insured's employee. However, in March of 2018, the Appellate Division, First Department, changed the game once more,
issuing a decision finding that, where the premises owner has been assigned sole proximate causation in the underlying action, the premises owner cannot obtain status as an additional insured under the employer's general liability policy. *Hanover Ins. Co. v. Philadelphia Indem. Ins. Co.*, 73 N.Y.S.3d 549 (1st Dep't 2018). As a result, it appears that Courts are interpreting *Burlington* to require proximate causation across the board, including those cases involving injuries to an employee.

(2) Does the *Burlington* decision have any effect on the duty to defend?

Under well-established New York law, the additional insured provision of a commercial general liability policy is triggered based on the four corners of the complaint. Despite *Burlington*, it appears that the law regarding the duty to defend remains unaltered. In *McCoy v. Medford Landing, L.P.*, the Appellate Division, Second Department, addressed this very issue, finding that the duty to defend is triggered, even where the underlying complaint has been dismissed. 164 A.D.3d 1436 (2d Dep’t 2018). In *McCoy*, the additional insured sought defense coverage of a personal injury suit, and moved for summary judgment on the issue. The summary judgment motion was denied, and in the interim the personal injury suit went to trial. During the appeal, the trial occurred and the jury verdict found in favor of the additional insured, dismissing the action in its entirety. Despite the fact that none of the parties were held liable for the damages alleged by the plaintiff, and therefore the accident could not have been "caused by" the acts or omissions of the named insured, the Second Department found that the insurer was nonetheless obligated to provide defense coverage to the additional insured. In so doing, the Court noted that the duty to defend is broader than the duty to indemnify, and where the allegations in the complaint suggest a reasonable possibility of coverage, an insurer owes defense. *Id.* Therefore it appears that, despite the fact that *Burlington* requires a trigger of proximate causation for the duty to indemnify to be triggered, no such requirement currently exists in order to trigger the duty to defend. Regardless of the potential (or lack thereof) that the claim was caused by the acts or omissions of the named insured, where a complaint contains such allegations, an insurer nonetheless has the duty to defend.

The First Department has also addressed this issue in *Indian Harbor Ins. Co. v. Alma Tower, LLC*. 165 A.D.3d 549 (1st Dep’t 2018). In its decision, the First Department found that a duty to defend arising where there is “a reasonable possibility” that the named insured "proximately caused the injury.” *Id.*

Other jurisdictions throughout the Country have come to similar conclusions as New York State, that the phrase “caused by” requires at least a 1 percent apportionment of fault for a trigger of liability, in contrast to “arising out of.” The United States District Court, Eastern District of Tennessee noted this, siting multiple other jurisdictions:

Other courts that have parsed the language have focused on the scope of the words “caused ... in part” and the degree of causation it requires. *See Gilbane Bldg. Co. v. Admiral Ins. Co.*, 664 F.3d 589, 597–98 (5th Cir. 2011). When resolving the issue, courts have typically held the required level of causation by the named insured to be minimal. *See Id.* at 601 (holding that named insured had to be only “1% or more responsible”); *see also Ramara, Inc. v. Westfield Ins. Co.*, 814 F.3d 660, 675–76 (3d Cir. 2016) (holding the language does not
require the named insured to be a “substantial factor” in causing the incident), *First Mercury Ins. Co. v. Shawmut Woodworking & Supply Inc.*, 48 F.Supp.3d 158, 173 (D. Conn. 2014), aff’d, 660 Fed.Appx. 30 (2d Cir. 2016) (“[T]he progression from ‘arising out of’ to ‘caused, in whole or in part, by’ shows that ... the amendment was intended to require proximate causation by the insured rather than simply but-for causation.”); *Thunder Basin Coal Co., L.L.C. v. Zurich Am. Ins. Co.*, 943 F.Supp.2d 1010, 1015 (E.D. Mo. 2013) (“By its plain language, the phrase “caused, in whole or in part,” merely requires the named insured or those acting on its behalf to have been at least partially responsible for the injuries alleged by the claimant.”).


II. **Variation on the Additional Insured endorsement: “When Entered Into Contract With You”**

One of the commercial construction industry’s standard methods of contracting for commercial construction projects is for an owner to enter into contract with a general contractor, who then in turn enters into contracts with subcontractors. This is and has been the standard practice of commercial property owners and contractors for decades. In doing so, the owners rarely enter into direct contracts with subcontractors. It is the general contractor who is required to enter into a contract with the various subcontractors, and to ensure that the provisions of the main contract with the owner are incorporated into the contracts with the subcontractors.

Despite this fact, several insurers are now offering a very limited version of the additional insured endorsement in their policies, two samples of which is provided below:

WHO IS AN INSURED (Section II) is amended to include as an insured any person or organization with whom you have agreed to add as an additional insured by written contract but only with respect to liability arising out of your operations or premises owned by or rented to you.

Alternatively:

**ADDITIONAL INSURED – OWNERS, LESSEES OR CONTRACTORS – AUTOMATIC STATUS WHEN REQUIRED IN CONSTRUCTION AGREEMENT WITH YOU**

This endorsement modifies insurance provided under the following:

**COMMERCIAL GENERAL LIABILITY COVERAGE PART**
**A. Section II- Who Is An Insured** is amended to include as an additional insured any person or organization for whom you are performing operations when you and such person or organization have agreed in writing in a contract or agreement that such person or organization be added as an additional insured on your policy. Such person or organization is an additional insured only with respect to liability for “bodily injury”, “property damage” or “personal and advertising injury” caused, in whole or in part, by:

1. Your acts or omissions; or
2. The acts or omissions of those acting on your behalf;

In the performance of your ongoing operations for the additional insured.

These new additional insured endorsements essentially preclude coverage for commercial property owners, often unbeknownst to the contractors who purchased the policies. While at first glance, the endorsement appears to be arguably ambiguous, the New York Court of Appeals recently found that endorsements similar to this are in fact unambiguous in that they do not provide coverage. In *Gilbane Building Co. v. St. Paul Fire and Marine Ins. Co.*, the Court of Appeals held that such language unambiguously required that in order for any party to be an additional insured it must have entered into a contract directly with the named insured. 31 N.Y.3d 131 (2018). Thus a construction manager was not considered an additional insured under the policy at issue because the construction manager did not enter into a direct contract with the named insured. The Court of Appeals also relied upon prior precedent set by the Appellate Division, First Department, in *A.B. Green Ganesvoort, LLC v. Peter Scalamandre & Sons, Inc.*, 102 A.D.3d 425 (1st Dep’t 2013).

Not only did the Court of Appeals find that an insured could only interpret this language as precluding coverage to any parties that it did not directly enter into contract with, but did so despite the fact that the insured was provided with a certificate of insurance that stated that the parties qualified as additional insureds. *Id.* at page 137. Thus, despite the fact that the named insured and the construction manager were provided with certificates of insurance stating that the construction manager was an additional insured, the Court of Appeals found the language nonetheless unambiguous so as to preclude coverage.

Despite the fact that New York has found the language unambiguous, other states have in fact found this language to be ambiguous when dealing with owners, general contractors, and subcontractors, all of whom entered into a chain of contracts requiring indemnification. In *Hobbs v. Shingobee Builders, Inc.*, the Michigan Court of Appeals found that such language does trigger the duty to defend a general contractor for injuries sustained by an employee of a subcontractor’s subcontractor. 2013 W.L. 5951707 (Mich. Ct. App. 2013). In the Third Circuit Court of Appeals, the Court did not even discuss whether the owner of a premises was entitled to coverage if it did not enter into a direct contract with the subcontractor, but instead viewed the coverage as if this language were not included in the policy endorsement. *Ramara, Inc. v. Westfield Ins. Co.*, 814 F.3d 660 (3d Cir. 2016).

The New York Court of Appeals appears to be the highest State Court that has rendered a decision on whether the language is ambiguous. It is likely that other jurisdictions will also follow suit.
III. The Antisubrogation Rule, Revisited.

Many jurisdictions have some form of the antisubrogation rule—essentially that an insurer cannot bring an action against one of its own insureds. However, can a CGL insurer bring a suit against a non-insured that shares in a separate wrap policy with the CGL insurer’s additional insured? This question is currently pending before the New York Appellate Division, First Department, in Old Republic Gen. Ins. Corp. v. K&M Architectural Window Products, Inc. In this action, Old Republic accepted coverage for two additional insureds, the general contractor and the property owner, under a CGL policy issued to a subcontractor electrician. The subcontractor electrician was not covered by a CCIP (wrap-up) policy. In doing so, Old Republic agreed to defend and indemnify the owner and general contractor in two separate personal injury actions commenced by employees of K&M Architectural Window Products, Inc. (“K&M”). Thereafter, Old Republic commenced an action in subrogation against K&M, seeking defense and indemnity from K&M.

Unlike Old Republic’s insured, K&M was insured under the CCIP policy obtained by the general contractor for the construction project. Therefore, K&M argued, antisubrogation applies, because K&M is insured under the same policy which insures the general contractor. K&M argued that, because the general contractor would be required to pay the policy deductible should Old Republic succeed in its action against K&M, the action was barred by the doctrine of antisubrogation, citing an unpublished decision, Parache v. Eleventh Ave., L.P., Index no. 100839/2009 (Sup. Ct. N.Y. Cty. 2013).

In opposition, Old Republic argued that the antisubrogation rule cannot apply to the action because the defendant is not insured by the policy issued by Old Republic. In Fitch v. Turner Construction Co., the First Department noted that, even where another insurer insures both parties, the antisubrogation rule is not applicable. 241 A.D.2d 166 (1st Dep’t 1998). At the Lower Court, the Court granted K&M’s motion for summary judgment, holding that the action was indeed barred by the doctrine of antisubrogation. Old Republic appealed, and oral argument was held in December of 2018. It is likely that regardless of the outcome, either party may appeal the decision to the Court of Appeals, as there has not been any decision squarely on point from the Court of Appeals that provides an answer to this question.
HOT CONSTRUCTION RISK TOPICS IN THE UK 2019

By: David Pryce and Amy Lacey

AUTHOR BIOS

David Pryce was a founding partner, and is the current Managing Partner, of Fenchurch Law, which was the first firm in the UK to focus exclusively on representing policyholders in insurance coverage disputes. Ranked in Tier 1 by Legal 500, and twice named Insurance Law Firm of the Year, Fenchurch Law is the current Lawyer Awards “Boutique Firm of the Year”, the most prestigious award available to niche law firms in the UK. David’s practice focuses primarily on construction related coverage disputes under a variety of policies, including Construction All Risks, Public & Products Liability, Latent Defects, and Professional Indemnity.

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The UK courts continue to grapple with complex issues concerning allocation of risk in the construction industry, reflected in a number of recent decisions on subrogation rights, co-insurance, and the interface between workmanship and design. The following are some recent UK decisions, and the effect they have on the industry within the UK.

I. Sub-Contract Insurance Obligation Precludes Coverage under Project Policy: Haberdashers’ Aske’s Federation Trust v. Lakehouse Contractors & Others

In Haberdashers’ Aske’s Federation Trust v. Lakehouse Contractors & others [2018] EWHC 558 (TCC), a main contractor entered into a project insurance policy including coverage for sub-contractors. However, the subcontractor in question was also required to procure a separate third party liability insurance policy, and works undertaken by the roofing sub-contractor led to a fire causing extensive damage to buildings. The project insurers indemnified the main contractor for in excess of £8 million and then sought to recover £5 million from the sub-contractor, arguing that the sub-contractor was not a co-insured (despite the fact that it was arguably an insured under the project policy) in circumstances where it had taken out separate third party liability insurance, as required under sub-contract terms.

The Court reviewed UK authorities on how sub-contractors obtain the benefit of project insurance policies and identified three different ways of analysing the situation: (1) based on agency principles, (2) a standing offer, and/or (3) acceptance by conduct. It was decided that, in any case, the roofing sub-contractor was not covered under the project policy (despite a waiver of subrogation provision in the policy), as the express contract term requiring separate coverage was inconsistent with any such intention. It was accepted that coverage would otherwise be available under the project insurance to sub-contractors as “additional insureds” for specified perils including fire damage.

The subrogated claim was limited to the extent of the sub-contractor’s insurance, leaving open the question of whether the project policy would partially respond to losses claimed against the sub-contractor in excess of policy limits. The Judge noted: “I doubt in the
commercial context that [the intention of the main contractor and the sub-contractor], objectively ascertained, would be that [the sub-contractor] would be exposed to the whole amount of the losses incurred on the occurrence of an insured event, regardless of any limit on the cover of the [sub-contractor’s own insurance policy]”.

The Judge’s conclusion that the sub-contractor was not co-insured at all under the project policy due to alternative insurance arrangements is surprising. Past caselaw has accepted that a double insurance situation may arise (with coverage under both policies) even where one policy was specifically intended to cover the loss in question. For example, the Court of Appeal held in Rathbone Bros v. Novae [2014] EWCA Civ 1464 that a party was insured under both a professional indemnity policy and a D&O policy, although the latter expressly provided that coverage applied “excess over more specific management liability insurance and indemnification”. However, it might be said that the express term in the D&O policy negated any suggestion that there was no coverage at all under that policy.

Some commentators have criticised the Haberdashers judgment from a policyholder perspective insofar as the project insurers believed they were covering all sub-contractors for this type of eventuality when writing the coverage and pricing the risk. The decision has caused alarm amongst sub-contractors and led to re-evaluation of insurance arrangements, suggesting that existing project policies may not respond to certain risks as previously expected.

Permission to appeal was granted with the case set to be heard by the Court of Appeal in late January 2019.

II. Design Defect Revisited: SSE Generation v. Hochtief Solutions

Energy firm SSE Generation was awarded in excess of £100m damages on appeal over a tunnel collapse in 2009 at the Glendoe hydroelectric power scheme in Scotland (SSE Generation v. Hochtief Solutions [2018] CSIH 26). The Inner House, Court of Session, decided by a majority of 2:1 that the contractor was liable for costs of repair due to breach of the requirement that erodible rock encountered in the tunnel be shotcreted (i.e. reinforced by concrete sprayed at high velocity) if not otherwise protected, despite having exercised reasonable skill and care, as defects were in existence at take-over by the owner. The contractor could not rely on a contractual limitation of liability for "design defects" as defined in the contract as the damage was caused by implementation. The dividing line between design and workmanship is often difficult to determine in practice, although the position was modified in this case by the contract terms.

Further, the Court held that there was no implied term preventing the owner from bringing proceedings against the contractor, notwithstanding a joint names construction all risks (CAR) policy that contained a waiver of subrogation, in view of contract provisions apportioning liability for claims due to events at each party’s risk. Consistent with Gard Marine v. China National Chartering Co [2017] UKSC 35, it was acknowledged that a requirement for joint insurance could lead to an implied term that claims between contracting parties for losses covered by the policy were not permitted, and the Supreme Court’s use of language in that case such as “inconceivable” and “absurd” when referring to the possibility of a subrogated claim were “powerful contra-indicators”. However, the joint insurance required under the Glendoe contract indemnified loss or damage to the works, not breach of
contract by the contractor in failing to carry out repairs, so the policy was held not to cover the employer’s claim on the facts in any event.

The CAR insurers were not a party to the litigation and the policy terms on defects exclusions are not referenced in the judgments. Project policies in the UK typically include a degree of coverage for damage caused by defects in design, materials or workmanship, excluding costs of putting right the defect itself. Standard forms of defect exclusion clauses (DE1-DE5 and LEG1-LEG3) are widely used in the market, providing different levels of cover. It is possible therefore that coverage may have been established under the CAR insurance, had a claim been pursued against the insurers, subject to policy terms.

The decision is also notable in considering the contractual requirement, in project documents describing the works to be completed on site, for a “design life” of 75 years. Following the Supreme Court decision in MT Højgaard v Eon [2017] UKSC 59, it did not mean the contractor was warranting that the works would in fact last for the specified period without major refurbishment or significant expenditure. Rather, the obligation was met if the contractor handed over the works with such a design life and the employer had the whole of the defects period to determine whether the works did in fact have that design life. The question of compliance therefore fell to be determined at the defects date, which may be difficult to assess in some instances, but not here, as the tunnel collapse had already occurred.

Permission to appeal to the Supreme Court has been granted, with the outcome keenly anticipated by UK practitioners.

III. Contractual Language May Prevent Subrogation: The Ocean Victory

In Gard Marine & Energy Limited v. China Nat’l Chartering Co. Ltd. (also known as "The Ocean Victory" the name of the vessel at issue), judgment was handed down in favour of sub-charterers of a bulk carrier destroyed during exceptionally adverse weather conditions at Kashima, Japan. The Supreme Court concluded that there was no breach of the safe port warranty, and Gard Marine as hull insurers were prevented from pursuing a subrogated recovery, in a case with significant implications for co-insured policyholders beyond the realm of marine risks.

The combination of long waves and gale force winds in the Fairway was an abnormal occurrence of extreme severity. This was the only time such an incident had occurred in the port’s 35 year history, and the insurers’ losses exceeded $137 million. Despite this, the insurers claimed that the loss was caused by problems known at the port by the charterers, and thus the loss was caused by the charterers breach of the safe port warranty. Thus, coverage initially stemmed from the answer to the following question: was the port considered safe? While the lower court found the port unsafe, the Court of Appeal and Supreme Court subsequently determined the port itself was safe, and therefore there was no breach of the safe port warranty.

Next, their Lordships went on to consider whether claims could in theory have been pursued by insurers against the various charter parties in the event of breach of warranty, with the majority deciding the joint insured owner and demise charterer were impliedly excluded from liability to each other for insured loss, in view of the agreed insurance arrangements. Lords Toulson, Mance and Hodge held that there was an implicit agreement the owners of the Ocean Victory would not be liable to sue the demise charterer, noting the commercial
The purpose of the contract to jointly insure the vessel for €70 million was not only to provide an insurance fund to make good any loss, but also to avoid litigation. Lords Clarke and Sumption in the minority disagreed on this aspect, deciding the co-insured demise charterer's liability to the owners was not excluded, and in the further alternative was satisfied by indemnity under the policy, so that insurers could in principle have pursued a subrogated recovery against the sub-charterers, had the safe port warranty not been complied with.

The juridical distinction between implied exclusion of liability between joint insureds or satisfaction of the loss by insurers is significant, particularly in circumstances where the limit of indemnity is inadequate; the insurer becomes insolvent or delays payment; or a related claim is pursued against a third party. The 3:2 split is likely to generate uncertainty and a full review of (at times conflicting) previous authorities in this area was not provided.

Multi-party insurance is especially common in construction projects, with policies against all risks of loss and damage to the works usually taken out in the joint names of employer and contractor. Whilst UK Courts have traditionally recognised that it would be nonsensical for parties with “pervasive interests” under a CAR policy to claim against each other for damage to contract works (see e.g. Petrofina v. Magnaload [1984] QB 127, Hopewell v. Ewbank Preece [1998] 1 Lloyd’s Rep 448), difficulties remain in identifying the extent of insurable interest (Deepak Fertilisers v. Davy McKee [1999] 1 All ER (Comm) 69) and the basis of implied waiver (Tyco Fire v. Rolls Royce [2008] EWCA Civ 286, Rathbone Bros) in each case.

It may be argued that (theoretically negligent) sub-charterers could escape liability as a result of the joint insurance coverage, on the majority Supreme Court reasoning, although conversely it was suggested that a demise charterer might be able to pursue a claim against sub-charterers on alternative bases that: (1) possessory title gave it sufficient interest to maintain a claim for damages, or (2) a “transferred loss” claim could be pursued to recover loss suffered by the owners.

IV. Conclusion

Performance obligations and insurance requirements in construction contracts must be carefully considered at the outset, in the context of overall project arrangements, to ensure appropriate allocation of risk and scope of cover. If the parties intend to create an insurance fund as the sole avenue for making good the relevant loss, this should be expressed in clear and unambiguous terms.

The majority decision in *Ocean Victory* is welcomed as a pragmatic approach to development of the rule preventing subrogation against a co-insured, to avoid the inconsistency of an insurer recovering from a party he has agreed to indemnify in respect of the same loss, and to limit the scope for coverage disputes with insurers.

In the absence of express contractual terms to the contrary, an implied term excluding liability between co-insureds will apply even if the loss was caused by the fault of one of them, but only to the extent the subject loss is itself insured, and a claim would not be barred if the party relying on the implied term had by his own conduct prevented recovery of loss under the policy. However, a sub-contractor agreeing to obtain separate liability insurance may be exposed to subrogated claims from any project insurer, even if the loss in question would otherwise be covered by the project policy.
Each case will turn on its own facts and the pending appeals in *Hochtief* and *Haberdashers Aske* are expected to shed further light on these often contentious issues.
NOTEWORTHY WEST COAST DECISIONS CONCERNING CONSTRUCTION PROJECT INSURANCE AND ADDITIONAL INSUREDs

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As we know, in insurance litigation, tenders of defense are common, particularly in the construction arena. As the process generally unfolds, general contractors and owners impose the contractual requirement that they be designated as additional insureds under the insurance policies of their subcontractors. Hence, when issues arise against owners and general contractors that relate to, or arise from a subcontractor’s work, these parties customarily tender their defense to the subcontractor, in reliance upon their “additional insured” status. Within this process, lies the question of when and under what factual circumstances a party’s “additional insured” (“AI”) status attaches, or whether mere, tangential involvement in a project as alleged in a vague, broadly articulated complaint is sufficient to trigger this status.

In early 2018, the Oregon Court of Appeals left no doubt that AI status is to be construed broadly, even where there exists little to no factual connection between the party seeking AI status and the work over which suit has been filed. In PHI Beaverton, LLC v. Red Shield, et al, a general contractor sought defense from its subcontractor’s insurer for construction defect claims brought against the general contractor. The subcontractor’s policy contained an AI endorsement which defined an insured as

“…any person or organization for whom [Subcontractor] is performing operations when [Subcontractor] is performing operations when [Subcontractor] and such person or organization have agreed in writing in a contract or agreement that such person or organization be added as an additional insured on [Subcontractor’s] policy. Such person or organization is an additional insured only with respect to liability arising out of [Subcontractor’s] operations performed for that insured. A person’s or organization’s status as an insured under this endorsement ends when [Subcontractor’s] operations for that insured are completed…”

On its face, this language would appear to contain qualifications which would make AI status somewhat more challenging to secure. To that point, the Subcontractor’s carrier contended (1) that the phrase “ongoing operations” should be interpreted to deny AI status since the lawsuits at issue did not allege that the general contractor was responsible for the Subcontractor’s operations, only that it was responsible for its own, (2), that the lawsuits at
issue did not allege liability under the phrase “ongoing operations” since the policy’s endorsements required such an allegation to trigger coverage, and (3) the lawsuits at issue contained no allegation that the property damage occurred “during the policy period” as the “Coverages” section of the policy required.

Ultimately, the Court rejected these arguments, holding first that the obligation of an insurer under a duty to defend arises where a complaint “rules in” coverage (i.e., whether “…a Court could reasonably interpret the allegations to include an incident or injury that falls within the coverage of the policy…”). Thus, in accordance with West Hills Development Co. v. Chartis Claims, 360 Or. 650, 385 P.3d 1053 (2016), because the general contractor was an AI under the subcontractor’s policy for its work on the project and “…the operative complaint asserted claims against the general contractor, giving rise to the possibility of the general contractor being subjected to liability and [limited] the additional insured’s coverage to liability arising out of the subcontractors’ ongoing operations performed for the general contractor…” Put differently, the Court read the qualification to the definition of “insured” so broadly as to strip it of any real meaning. Essentially, the Court concluded that merely because the complaint made non-specific factual references to the general contractor having “hired, supervised and inspected the work of subcontractors”, that coverage for the general contractor as an AI was implicated. This, despite the fact that the general contractor was never mentioned by name and its culpability was articulated solely in theoretical terms (i.e., the complaint could be reasonably interpreted to implicate the general contractor.)

The Court also rejected the contention that the phrase “ongoing operations” presented a temporal limitation that would deny AI status in the presence of a vaguely drawn complaint. Surprisingly, the Court determined that this same vagueness was “sufficiently indeterminate to permit the possibility” that the claimed damage occurred during the general contractor’s “ongoing operations” at the project. Thus, despite the fact that the operative complaint had no specific dates of defective work allegedly performed and references only “ongoing” damages, these allegations were deemed sufficient to implicate coverage for the general contractor as an AI.

Finally, the Court dismissed the idea that the lack of an alleged occurrence “during the policy period” was sufficient to preclude coverage, holding that under the “four-corners rule, the extrinsic evidence offered by [the subcontractor] – the timeframes in which [the plaintiffs in the construction defect action] likely purchased their hotels – is not to be considered…” Ultimately, the Court took the unlikely position that “…because [the subcontractor’s] argument is premised on the fact that the hotels were purchased after the policy period ended – a fact we cannot consider without resorting to extrinsic evidence – we do not reach it…”

Another exploration of these issues that comes to a much different conclusion may be found in Absher Construction Company v. North Pacific Insurance Co., 3:2010-cv-05821, ECF No. 82 (W.D. Wash. 2012). There, a federal court concluded that Plaintiff, Absher Construction, had no entitlement to defense from the carrier of Absher’s subcontractor, One Beacon Insurance since the applicable insuring agreement limited coverage to “ongoing operations”. Borrowing from the thinking in Hartford Insurance Co v. Ohio Casualty Insurance Co., 189 P.3d 195 (Wash. Ct. App. 2008), the Absher court defined “ongoing operations” narrowly, interpreting it to refer to “…liability that arises while the work is still in progress…” In denying coverage to Absher under the narrowly drawn standard of “ongoing operations”, the Court emphasized that the underlying complaint failed to expressly
name Absher in its text and indicated that the damage at issue occurred “after completion…” Thus, on nearly identical facts, this Court came to a conclusion diametrically opposed to PHI Beaverton, LLC, discussed above. To be clear, however, Absher represents the prevailing judicial approach to these issues on the west coast.

These decisions are significant in that they speak to the extent to which the factual threshold for an AI to successfully tender its defense in a construction defect action has been weakened in recent years (via cases such as PHI Beaverton, LLC) such that broadly drawn exceptions within policy language almost swallow entirely the rules to which they attach.


Another issue that frequently arises in the context of parties claiming AI status and potential tenders of defense is that of divergent ethical interests (i.e., under what circumstances is it warranted for an insurer to secure independent counsel for an AI that believes its interests are not adequately protected by counsel for the underlying insured?) In Centex Homes v. St. Paul Fire and Marine Insurance Company, a group of homeowners filed suit against Centex Homes (“Centex”) (their developer) regarding work performed by a subcontractor, Oak Leaf Landscape, Inc. (“Oak Leaf”) on a Centex project. Oak Leaf was insured with St. Paul Fire and Marine Insurance Company (“St. Paul”), to whom Centex tendered defense since the lawsuit was concerned with work performed by the subcontractor, Oak Leaf. St. Paul ultimately accepted Centex’s tender of defense, subject to a reservation of rights, one of which was the right to choose defense counsel for the action.

Sometime later, Centex commenced suit against fifty-seven (57) subcontractors who performed work on the project at issue for indemnity, contribution and other remedies. Two causes of action in this suit sought declaratory relief against St. Paul. The first claim alleged that St. Paul was obligated to defend Centex as an AI and contended that St. Paul’s acceptance of Centex’s tender pursuant to a reservation of rights was a breach of its duty to defend Centex as Oak Leaf’s AI. Centex argued that factual disputes as to whether St. Paul had the right to be reimbursed for defense costs and under what circumstances, left Centex with a live controversy that necessarily required retention of conflict counsel on Centex’s behalf.

The second claim contended that St. Paul was obligated to provide Centex with a “full, complete, immediate and conflict-free defense”, arguing that by defending Centex pursuant to a reservation of rights and appointing panel defense counsel to handle the action, St. Paul created a conflict of interest which triggered Centex’s entitlement to independent counsel.

In approaching Centex’s first declaratory relief cause of action, the Court determined that all of Centex’s concerns about conflicts of interest were more potential than actual. In the Court’s words,

It is still unknown whether Oak Leaf’s work caused the property damage claimed by the [homeowners]. The proportionate liability of all the subcontractors has also not been adjudicated. The amount of defense fees has not been established in the underlying litigation.
Quite simply, there are simply not enough facts about liability, damages, or the cost of defense for the trial court to offer any declaration as to the rights and obligations of the parties…

Turning to Centex’s second declaratory relief cause of action, the Court concluded, “…a reservation of rights by [an] insurer does not necessarily constitute a conflict of interest requiring the insurer to provide independent counsel. The conflict must be ‘significant, not merely theoretical, actual not merely potential…” (citing, Dynamic Concepts, Inc. v. Truck Insurance Exchange, 61 Cal.App.4th at 1007.)

The Court also added “…an insurer has the right to control a defense.” (citing, James 3 Corp. v. Truck Ins. Exchange, 91 Cal.App.4th at 1102-1103, 111 Cal.Rptr.2d 181.) Thus, Centex’s expressed concerns about St. Paul (or its’ chosen counsel) making strategy decisions in the underlying action so as to prejudice Centex or manipulating experts to its advantage so as to decrease Centex’s ability to avoid liability for damages claimed in the underlying action were deemed premature. In the Court’s words, “…there is no there there…” While the Court did leave open the possibility of revisiting these causes of action once liability among the parties in the case became more developed, it concluded that these causes of action were not ripe for adjudication and were properly dismissed.

This case provides an important example of the limitations in representation that an AI must necessarily endure when a subcontractor’s insurer accepts an AI’S tender of defense. In California, at least, the mere acceptance of a tender of defense does not, by itself, confer upon an AI the ability to dictate the precise manner in which such a defense is provided. What is also clear is that courts will consider such conflict of interest allegations once a factual record in the action has been developed and the respective interests of each party become clearly understood.

Interestingly, the Nevada Supreme Court came to a similar resolution of these issues in State Farm Mut. Auto Ins. Co. v. Hansen, 357 P.3d 338 (2015), where the Court embraced the idea that “…Nevada, like California, recognizes that the insurer and the insured are dual clients of the insurer-appointed counsel…” Yet, the Court also articulated the issue slightly differently, holding that “…a reservation of rights does not create a per se conflict…Courts must inquire, on a case-by-case basis, whether there is an actual conflict of interest. This approach follows Nevada law: We have held that dual-representation is appropriate as long as there is ‘no actual conflict’ See, Nevada Yellow Cab, 123 Nev. at 51, 152 P.3d at 741…”
DISASTER STRIKES—INSURANCE IMPLICATIONS OF A CONSTRUCTION CALAMITY

Panelists:

David Pryce
Owner
Fenchurch Law Ltd.

Ken Maguire
Partner
Ken Maguire & Associates, PLLC

Richard Dreitzer
Partner
Wilson Elser Moskowitz Edelman & Dicker LLP

Moderator:

Kate Maguire
Partner
Ken Maguire & Associates, PLLC
The State of New Canada was formed in 2001.
New Canada looks to all US Courts and British common law for legal precedents.
The recently formed State of New Canada’s capitol, New Canada City has a congested downtown area.

The University of New Canada is located in the heart of downtown New Canada City, and sprawls over 100 acres, with a student body of 25,000 students.

Lincoln Boulevard, one of the most traffic-heavy streets downtown, runs straight through the University.

The University has secured funding to erect a pedestrian bridge.
On January 5, 2015, the University of New Canada entered into contract with engineering firm Bridges-R-Us LLC in connection with designing the new pedestrian bridge.

On November 5, 2017, the University of New Canada entered into contract with Greatest Contractors, Inc. to act as general contractor and commence construction on the bridge, which began on November 20, 2017.
The Collapse Occurred when Rock Solid Concrete, Co. was in the process of finishing concrete pouring, resulting in the death of 1 employee and injury of 2 employees.

Engineers believe the cause of the collapse was a last minute change in the design of the steel rebar utilized in the structure, which was recommended and installed by Steel Kings, Inc.
POLICIES AT PLAY

- **University of New Canada**
  - CGL policy, $2 million per occurrence
  - Commercial Property policy, $3 million per occurrence
  - Three commercial excess policies, limits of $10 million
- **Greater Contractors, Inc.**
  - CGL policy, $2 million per occurrence limit
  - Commercial excess policy, $15 million limit
- **Bridges-R-Us, LLC**
  - Professional liability policy, $2 million per occurrence
  - CGL policy, $1 million per occurrence limit
  - Commercial excess policy, $10 million limit
- **Steel Kings, Inc.**
  - CGL policy, $5 million per occurrence
  - Two excess policies, $5 million and $10 million limits
- **Rock Solid Concrete, Co.**
  - CGL policy with limits of $1 million per occurrence
  - Excess policy with $5 million limit
  - Workers compensation and employee liability policy with limit of $2 million per occurrence
WHO IS AN INSURED (Section II) is amended to include as an insured any person or organization with whom you have agreed to add as an additional insured by written contract but only with respect to liability arising out of your operations or premises owned by or rented to you.
“WHEN REQUIRED IN CONSTRUCTION AGREEMENT WITH YOU”

ADDITIONAL INSURED – OWNERS, LESSEES OR CONTRACTORS – AUTOMATIC STATUS WHEN REQUIRED IN CONSTRUCTION AGREEMENT WITH YOU

This endorsement modifies insurance provided under the following: COMMERCIAL GENERAL LIABILITY COVERAGE PART

A. Section II- Who Is An Insured is amended to include as an additional insured any person or organization for whom you are performing operations when you and such person or organization have agreed in writing in a contract or agreement that such person or organization be added as an additional insured on your policy. Such person or organization is an additional insured only with respect to liability for “bodily injury”, “property damage” or “personal and advertising injury” caused, in whole or in part, by:
1. Your acts or omissions; or
2. The acts or omissions of those acting on your behalf;
   In the performance of your ongoing operations for the additional insured.
The purpose of this article is to warn lawyers that much of their conduct in mediation may violate Rule 1.1, ABA Model Rules of Professional Conduct (in California, Rule 3-110, Rules of Professional Conduct), and to suggest how lawyers can make their mediation advocacy more ethical and more effective at the same time.

Here’s the problem: Lawyers too often delegate to mediators tasks which clients are entitled to have professionals with a duty of undivided loyalty — their own lawyers — perform, and which the ethical rules require those lawyers to perform. The solution? Lawyers must understand which tasks they must perform themselves, then perform those tasks.

To understand this fully, we will explore the governing rules, lawyers’ obligations to their clients under those rules, how lawyers’ conduct in mediation commonly violates those obligations and how lawyers can do better.

The Rules

The ABA’s model governing rule is straightforward: “A lawyer shall provide competent representation to a client.”[1] The California analog is similar: “A member shall not intentionally, recklessly or repeatedly fail to perform legal services with competence.”[2] The official discussion of rule 3-110 makes clear that “The duties set forth in rule 3-110 include the duty to supervise the work of subordinate attorney and non-attorney employees or agents.”
The Obligations

Flowing from these rules, what obligations do lawyers have in the delegation of client responsibilities to others and the supervision of those others’ work?

The California Supreme Court described those obligations well in Moore v. State Bar. In that case, David Moore was a lawyer hired to represent a client in what appears to have been a collection action. Moore delegated virtually all responsibility for the matter to another attorney, who was suspended from practice at the relevant times. The second lawyer ignored the file. The client ended up with a default judgment against him. Moore had his license suspended for 90 days.

Here’s why:

The court initially held a lawyer to “professional obligations of service and protection to a client.” Those obligations are largely non-delegable. The court rejected Moore’s assertion that he hired the second lawyer to assist and “had the right to rely upon [the second lawyer's] integrity and ability.”

In the key sentence of the opinion, the court chastised Moore for relying on another so completely: “(Moore) thus mistakenly places himself in the position of his client rather than in that of his client’s lawyer.”

What was Moore obligated to do? The court continues: “It was (Moore) who had accepted [the client] and it was upon (Moore) that [the client] was entitled to rely for the required legal service for which he had advanced costs and a retainer.”

This language leaves open the next question to which we must turn: What is within the scope of the “required legal service” a lawyer herself is required to provide?

In 1990, the California Supreme Court answered that question in Morgan v. State Bar. There, Morgan was disbarred for practicing law while still under suspension for previous misconduct. The court held:
The practice of law includes not only appearing in a court of law but also the giving of legal advice and counsel and the preparation of legal instruments and contracts by which legal rights are secured although such matter may or may not be pending in a court. … Similarly, we conclude that engaging in negotiations with opposing counsel regarding settlement … constitutes the practice of law.[9]

In short, when clients hire lawyers, they are entitled to have lawyering tasks performed by their lawyers, the professionals who must “conform to professional standards.”[10]

Lawyers may not delegate lawyering tasks without supervision, and surely may not delegate lawyering tasks without supervision to someone who does not conform to a lawyer’s professional standards. So problems arise when a mediator is assigned, or is allowed to seize, lawyering tasks.

Even if the mediator is a lawyer, when she functions as a mediator she does not function as your client’s lawyer and does not conform to the same professional standards as you do. You owe your client a duty of undivided loyalty.[11]

The mediator (whether a lawyer or not) owes your client no such duty; the mediator is hired by both sides, is compensated by both sides, works for both sides. While the mediator’s professional standards may not always be settled or clear, one thing is sure: The mediator’s professional standards are not the same as yours. A lawyer may not delegate lawyering tasks without supervision to a mediator, or allow a mediator to seize those tasks.

The Violations

Lawyers’ conduct in mediation commonly violates these obligations, and therefore violates ethical rules, in at least three ways: Lawyers delegate, or allow mediators to seize, unsupervised authority to draft confidentiality agreements; to engage in settlement negotiations with opposing counsel; and to draft settlement agreements.
Confidentiality agreements

When was the last time you drafted, or negotiated, a mediation confidentiality agreement? Probably never. Commonly, the mediator gives you her preprinted form at the beginning of the mediation day. You don’t read it, you just sign.

Yet we know from Morgan v. State Bar that “the preparation of legal instruments and contracts by which legal rights are secured” is a lawyering task. And the mediation confidentiality agreement is just such a document. It secures — or, more frequently, forfeits — your client’s legal rights. When you blithely sign whatever the mediator puts under your nose, can you honestly say that you have discharged your ethical obligation to supervise the mediator adequately, or even at all?

The forfeiture of legal rights you commonly agree to in a mediator’s standard confidentiality agreement can be substantial, and prejudicial to your client, in at least two ways.

First, you may forfeit the ability to hold the mediator accountable for malpractice. Mediators commonly slip prospective waivers of liability into confidentiality agreements, a la this: “The participants hereby agree that the Mediator has no liability for any act or omission in connection with or arising out of the mediation.”

This has nothing to do with confidentiality. It just forfeits rights your client otherwise may have. What’s the chance you would include this forfeiture in a confidentiality agreement you drafted yourself? What’s the chance you would allow this forfeiture to remain in a confidentiality agreement whose preparation you adequately supervised?

Second, you may forfeit contract-based defenses — fraud, duress and mistake — to the enforcement of mediated settlement agreements. This was the situation in which the famous Winklevoss twins found themselves when they settled their securities litigation against Mark Zuckerberg.[12]

The twins asserted that Zuckerberg had misled them, at the mediation, about the value of their Facebook shares, and opposed enforcement of the mediated settlement agreement on grounds of fraudulent inducement. In the absence of the mediator-drafted confidentiality
agreement, Rule 408, Federal Rules of Evidence, would have governed, and the twins would have been allowed to introduce their evidence of the alleged fraud. But the mediator induced everyone to sign a confidentiality agreement which provided that “(n)o aspect of the mediation shall be relied upon or introduced as evidence in any arbitral, judicial or other proceeding.”[13]

The district court excluded the proffered evidence and enforced the settlement agreement, and the Ninth Circuit affirmed. Query: Did the twins’ lawyers fulfill their ethical obligations to represent their clients competently when they delegated to the mediator, unsupervised, responsibility for a confidentiality agreement which prejudiced their clients so badly?

**Negotiations with opposing counsel**

How often does your mediation start with your mediator (or a receptionist) escorting you to Conference Room East, and the other side to Conference Room West, and never the twain do meet? How often does the mediator ferry all offers and demands back and forth? You never quite know how faithfully the mediator is reporting your message to them or theirs to you.

How often does the mediator school you as to what your next number really has to be? And, finally, how often does the mediator lay down the law that once the number reaches a certain point, you have to take the deal? Isn’t mediation of this type starting to sound like, under the forbidden standard of Moore v. State Bar, you are placing yourself in the position of your client rather than your client’s lawyer? It’s hard to find any part of the negotiations with opposing counsel which you are conducting yourself.

The problems with mediation of this type are not merely abstract, they are quite concrete. Consider the oft-discussed hypothetical where the plaintiff’s bottom line and the defendant’s top dollar overlap. For example, a plaintiff’s bottom line is to take anything over $80, a defendant’s top dollar is to pay anything under $100. Obviously, this case should settle. But where?

A lawyer is obligated to push the number as close to their end of the range as possible. A mediator is not. If a mediator tells this plaintiff the best he can get her is $80 or tells this
defendant the best he can get her is $100, the case settles and the problems are obvious. The mediator may have picked a number that benefits a repeat-player or otherwise-favored client; the mediator may have a bias or prejudice, conscious or subconscious, for or against one side or another (opportunistic plaintiffs? stingy insurance companies?); or the mediator may have opera tickets that night and just want to get out of there once he gets the other side to the minimally-acceptable point in your zone of possible agreement.

The lawyers may have been able to do better for their clients. But they didn’t even try. Responsibility for the negotiation has been abandoned to the mediator. How can these lawyers say they have discharged their duty to represent, to act on behalf of, their clients competently?

**Settlement agreements**

How often does your mediation end with your mediator springing a settlement agreement on you, as full-blown as Athena from the brow of Zeus? In defense of this practice, mediators commonly say they are lawyers too; they know all about whatever kind of case is being mediated and how these cases typically settle; they have seen a million settlement agreements and know, often better than the lawyers, what these settlement agreements should say; there’s no need to waste time letting a bunch of contentious lawyers draft something from scratch; and everyone is entitled to the benefit of the fruits of the mediator’s lawyering skills.

Actually, no.

Clients are entitled to the benefits of their own lawyers’ lawyering skills. Those are the lawyers the clients have hired to perform lawyering tasks on their behalf. From the mediator, everyone is entitled to the benefits of mediation skills. Mediation skills are different than lawyering skills, and to be a mediator is different than being a lawyer.

Were it otherwise, every lawyer would be a good mediator, and we know that’s not so. Because being a mediator is different than being a lawyer, non-lawyers can (and do!) serve as mediators at very high levels of skill. It’s also why mediators who are also lawyers can serve as mediators without violating certain fundamental rules of legal ethics, such as the
prohibition against lawyers working for both sides to the same lawsuit.

Lawyers are generally competent to prepare their own settlement agreements. It’s likely that not only the mediator, but also the lawyers, have worked on similar cases before and have precedent forms of settlement agreements on their laptop computers. With the mediator as a chaperone, lawyers are usually able to work collaboratively enough to produce a settlement agreement.

And not every term of a settlement agreement is cookie-cutter. Some, such as the scope of a release or the extent of a confidentiality obligation, are frequently customized. What if the mediator’s “standard” language does not protect your client? It can be an uphill fight to eliminate language the mediator has blessed as “standard.”

When the lawyers work together to draft these terms, they eliminate the risk that the mediator’s language will prejudice their ability to produce an agreement that protects their client. As with confidentiality agreements, a mediator-drafted settlement agreement mistakenly places a lawyer in the position of their client rather than in the position of their client’s lawyer.

The safest harbor for lawyers is never to allow a mediator to hold the pen or touch the keyboard when it’s time to draft the settlement agreement. Even if the mediator is coaching or suggesting language, the ultimate decision as to the language to include will then belong to the lawyers, who appropriately will be the settlement agreement’s authors.

The Cure

The cure is obvious. In mediations, to discharge your ethical obligations to your clients, lawyers must neither delegate nor allow mediators to seize inappropriate responsibilities. When lawyers do delegate responsibilities to mediators, lawyers must make sure they are supervising the mediator, not the other way around.

Lawyers should not blithely sign whatever confidentiality agreement a mediator puts under their nose. Lawyers themselves should conduct as much of the face-to-face settlement negotiations as possible, and when they delegate to the mediator the task of face-to-face
communication, lawyers should make sure they are supervising the mediator.

Lawyers should always draft their own settlement agreements. Then, lawyers are engaging in good mediation, in which the mediator is facilitating the lawyers’ negotiation. This is in contrast to bad mediation, in which lawyers rely excessively on the mediator to negotiate for them.

The dividing line between ethical and unethical conduct by lawyers in mediation will depend on all the facts and circumstances and will be a matter of degree. This much, though, is pretty clear: If the mediator drafts a nonnegotiable confidentiality agreement, if you have no face-to-face communication with anyone from the other side and if the mediator drafts a nonnegotiable (or even awkward-to-negotiate) settlement agreement, you’re probably on the wrong side of that line.

Finally, why should we bother with this as an ethical issue at all? After all, your state bar disciplinary cops are not likely to raid your mediation or haul you up on charges for excessive delegation of responsibility to mediators. Fear of getting caught, though, is not the reason most lawyers follow the ethical rules.

While Model Rule 1.1 and California Rule 3-110 hold lawyers to a standard of competence, almost all lawyers I know hold themselves to a standard of excellence. The best lawyers won’t play cute with these rules and test their boundaries. The best lawyers will want to stay well within these rules and make sure they provide excellent and ethical representation to their clients. To accomplish that, the best lawyers will perform lawyering tasks themselves, and not delegate excessive or unsupervised responsibility for those tasks to mediators.

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[5] Id. at 77.

[6] Id.

[7] Id. at 80.


[9] Id. at 604, internal quotes and citations omitted.


[13] Id. at 1041.
FEATURED IN THIS ISSUE:

MCLE Article: Ethics and Social Media: A Critical Juncture
Megan Zavieh, p 14

Attracting Your Ideal Client Without Breaking a Sweat or the Bank
Dina Eisenberg, p 18
How can solos and small-firm lawyers—the Davids—ever get a fair shake in mediation against the Goliaths? Actually, it’s easy, and this article will explain how.

First, let’s ask, who are these “Goliaths” whom the solo and small-firm “Davids” fear? Are they your big-firm opposing counsel? The international corporations and insurance carriers you’re suing? No. If you’re well-prepared and conscientiously put your client’s interests ahead of your own, big-firm opposing counsel and their hoary clients won’t scare you.

I learned this in dramatic fashion from a small-firm “David” who was actually named Don. Don’s clients had a legal malpractice claim against a senior partner in a big firm, the kind of firm that has its name on the side of its building. This defendant was represented by two senior partners from another big firm, which also has its name on the side of its building (probably several buildings across the country). We had four mediation sessions spanning fifteen months. The two big firms tried to wear Don down, but he wore them down instead. His clients received a large, fair, settlement.

Afterward, Don told me his secret, the key to his approach. He said that he’d been in small firms for his entire forty-year career, almost always against large opponents. As he recounted it to me, his mentor taught him always to remember that it comes right down to—whether it’s the key deposition, standing up in court on major motions, trial—it’s always really just one lawyer against one lawyer. If you’re better prepared, there’s nothing to fear.

One lawyer against one lawyer! Like Dempsey against Tunney, the Dodgers against the Giants, Evert against Navratilova, it’s a battle of titans and a fair fight. No, big-firm opposing counsel and their clients are not the “Goliaths” the small-firm “Davids” fear.

Rather, the “Goliaths” the small-firm “Davids” have to fear are, sadly, mediators. If the mediator is against you and aligned with your big-firm opponents, you’re on the short end of a two-on-one, and the fight is not fair.

Over the years, countless solo and small-firm “Davids” have expressed this concern about mediators. This fear will never go away. Solo and small-firm “Davids” will always ask, “How can we protect ourselves from the risk the mediator will put his thumb on the scale for the big guy, the repeat player, the fellow member of his establishment?”

To find the answer, we first need to identify the source of the mediator’s potential power to tilt the scales against you. Then, we can figure out what to do about it.

While this may surprise you, the source of the mediator’s potential power to tilt the scales against you is... You! Yes, your own decisions and conduct in the mediation are what give the mediator the potential power to abuse you and your client.
Let’s consider the nightmare scenario solo and small-firm “Davids” fear most. As you enter the mediation, you and the plaintiff you represent have analyzed the case and decided you should settle for no less than 80 (on a scale of 1-100). After hours of wrangling, you have reduced your demand from 125 (admittedly, an extreme opening demand) to 85, and told the mediator you’re getting close to the end of your rope.

Down the hall, the defendant’s team tells the mediator that while they could pay up to 90 to settle, it would really make them look good in their supervisors’ eyes if they could bring this in around 75. They remind the mediator—as if they need to—that they are big clients for him, and for the mediation company where he works, and (cracking their knuckles as they speak), they look forward to many, many more mediations together.

As this nightmare scenario continues, the duly chastened mediator walks into your room, head bowed, shoulders slumped. He sits down and slowly looks up, brow furrowed. His eyes balefully look skyward. “I’ve tried everything, everything, with them,” he sighs and shrugs. “I’m so sorry. They are just so stubborn. It’s like talking to a wall. I begged them to be more reasonable. But the most I can tell you they will pay, the top, is… 70.”

Seventy! You’re shocked. The case is worth more and everyone knows it. Your client can barely handle the stress of litigation, though, and would sure rather get cash now instead of years from now, after trials and likely appeals. Still… 70…? You look the mediator dead in the eye and tell him you need more. You lower your demand to 80 and tell the mediator it’s your bottom line. You look serious. The mediator nods glumly and leaves.

Next, the mediator goes downstairs for a smoke. He returns a couple of unrelated calls. After a while, he comes back and tells you he has decided to make a “Mediator’s Proposal” at (you guessed it) 75. The mediator says that, while it may be a tough sale, he thinks the other side will bite. In fact, he may or may not have communicated a Mediator’s Proposal at 75 to the other side at all. It’s not actually necessary; he knows he has the 75 in hand as his repeat customer’s dream-come-true number.

You are in a pickle. While 75 is not enough to be fair, it’s not so unfair as to be dismissed out of hand. And, the mediator has put his imprimatur behind it. When you talk to your client about 75, he starts to sweat. Seventy-five! It’s not enough. But, he’s not a wealthy man, either. When was the last time he saw that much money in one place? His thinking dances with what he could buy with the 75 in hand (less your fee and his costs, of course). He starts thinking about getting his life back when litigation ends. Then he blinks. He says yes. He takes 75.

Despite lingering doubts because of the lack of transparency of it all, you think the mediator is somewhat of a hero for getting the big, bad defendant all the way up to 75. But the defendant would have settled at anything up to 90. The mediator has played you for a fool.

Have you been there? Have you been there, and not been aware you were there?

More importantly, what can you do to make sure you are never stuck there (again)? How can you take care that a mediator never becomes “Goliath” to your “David,” and uses his power to tilt the playing field against you? To answer this question, we must return to the issue of how mediators get the powers of “Goliath.” Then, the contours of an appropriate ounce of prevention become clear.

REMEMBER THE SOURCE OF THE MEDIATOR’S POWER—IT’S YOU!

A famous anecdote proves the point. It’s the story of the extraordinary Brendan V. Sullivan, Jr., of Washington, D.C.’s Williams & Connolly, best known for his defense of U.S. Marine Lieutenant-Colonel Oliver North in the aftermath of the Iran-Contra scandal in the 1980s. According to Sullivan’s Wikipedia page,

Sullivan shot to national prominence in 1987, when he represented Oliver North in televised congressional hearings over the Iran-Contra scandal. During the hearings in front of the Joint House-Senate Iran-Contra Committee, chairman Daniel Inouye suggested that North speak for himself, admonishing Sullivan for constantly objecting to questions posed to North. Sullivan famously responded,
“Well, sir, I’m not a potted plant. I’m here as the lawyer. That’s my job.”

Yes, a lawyer is not a potted plant. Yet at too many mediations, lawyers act like potted plants allowing mediators to take primary (or even sole) responsibility for conducting face-to-face communications with the other side and drafting the contracts (confidentiality agreements at the beginning, and settlement agreements at the end) which often bookend the mediation day. Lawyers too often sit by, intimidated by the mediator’s high status or forceful personality, as mediators seize, and lawyers acquiesce in the mediator’s seizure of, excessive responsibility for what goes on.

This acquiescence by lawyers can raise serious ethical as well as practical problems. Rule 3-110, California Rules of Professional Conduct, limits the extent to which lawyers can delegate responsibility for lawyering tasks to others who do not have the lawyer’s professional responsibilities—including the duty of undivided loyalty—to their clients. This limitation continues in new Rule 5.3, California Rules of Professional Conduct, effective November 1, 2018. Mediators, whatever their ethical duties are or aren’t, do not have a duty of undivided loyalty to anyone. Mediators work for all sides. Therefore, mediators are clearly in the class of people to whom lawyers cannot delegate excessive responsibility for lawyering tasks. Drafting contracts and conducting face-to-face negotiations are, equally clearly, lawyering tasks.

DON’T GIVE MEDIATORS THE POWER TO HARM YOU

The solution to the problem is now straightforward. Remember that the mediator works for you, you do not work for the mediator. You must supervise the mediator, the mediator must not supervise you. Ultimate responsibility for the representation of your client’s interests belongs to you and you alone, not to the mediator. While lawyers work in concert with mediators and value the mediator’s counsel and input (the mediator, after all, sees things at the other end of the hall which you never see), as far as your client is concerned, the buck always stops with you. So you must keep more responsibility for lawyering tasks yourself. When you do not delegate those tasks to the mediator, the mediator never gets the opportunity to use the power to perform those tasks against you.

Here are some concrete steps you can take:

Exchange Mediation Briefs

When you exchange mediation briefs, you control the message the other side gets about your case, and the message you get about theirs. You and the other side can prepare more comprehensively to join the issues and move them forward more efficiently on the mediation day. Sure, the mediator will have input, some of it perhaps highly evaluative. But both you and the other side will have the primary sources for evaluation, your respective analyses of the case in the mediation briefs, unfiltered by the mediator’s biases (and everyone has biases).

Have an Opening Joint Session

A critical part of the mediator’s job in 2018 is to determine whether an agenda can be tailored for an Opening Joint Session which will be productive and constructive. The so-called “plenary” Opening Joint Session of the 1990s (where the mediator asks one side’s lawyer “what do you have to say?” and then asks the other side’s lawyer “what do you have to say?”) is no more utilized today than the 1990s hit “Macarena” is still played at weddings and Bar Mitzvahs. Both seem quaint and outdated.

In 2018, when a mediator can read the briefs and talk to the lawyers before the mediation day, and the lawyers can read each other’s briefs, all involved can often work together to find issues which can be discussed directly in an Opening Joint Session, without being filtered through the mediator’s biases, to move the negotiation forward. Many times, a good issue for this agenda is the measure of damages. This issue rarely involves direct criticism of a party’s conduct and is often key to the appropriate settlement amount.

When you insist on delivering and receiving messages directly, you take power back from the mediator. The mediator loses the power to deliver messages in a way that doesn’t serve your interest. Neither can the mediator deliver the other side’s message to you in a way that may exaggerate its merit.
Of course, there will always be a few cases where mediation briefs should be confidential and the sides should not sit in a room together. When Opening Joint Sessions are curated, not plenary, though, the number of cases where you should avoid them will fall.

**Conduct Face-to-Face Negotiations Yourself**

As long as mediators take sole responsibility for running offers and demands back and forth with so-called “shuttle diplomacy,” solo and small-firm “Davids” will never lose the fear that the mediator may manipulate the negotiation against them and in favor of the large repeat players on the other side. The answer? Do more of this important work yourself, in consultation with and chaperoned by the mediator as necessary.

Here’s how it may look, in a nutshell:

After a curated Opening Joint Session, the mediator meets (typically) with the plaintiff’s side to discuss the issues further and formulate an opening demand. The mediator, having had some communication with the defense side, can offer some informed opinions (without violating confidences) about how the defense might respond to whatever the demand might be.

Plaintiff’s counsel and the mediator might then meet with defense counsel, an “attorney summit.” Either the mediator, or more likely plaintiff’s counsel, might express the opening demand. It generally has greater conviction when plaintiff’s counsel does it. Plaintiff’s counsel can judge defense counsel’s response directly, and answer any questions. This provides valuable, unfiltered information in both directions. It deprives the mediator of the power to tell plaintiff’s counsel that defense counsel was any more shocked by the opening demand than they actually were. Counsel then report back to their clients, with or without the mediator’s assistance as appropriate. This process of attorney summits and private conversations between lawyers and their respective clients can continue through several rounds of negotiation. Sometimes, but less frequently, it may be appropriate for a mediator alone to shuttle an offer or demand.

Ultimately, the defense may make an offer and say it’s their top dollar. When plaintiff’s counsel reports this to her client, her client will almost surely ask, “Do you believe that’s all we can get?” Plaintiff’s counsel must be able to answer with a convincing “yes” before plaintiff will consider accepting, for this “top dollar” will almost certainly be below plaintiff’s subjective evaluation of what the case is worth. How much better it is for plaintiff’s counsel to be able to answer that question after hearing defense counsel say it directly, rather than relying on what may be the manipulative or biased hearsay statement of the mediator as to the defense side’s state of mind. Again, direct communication deprives the mediator of the power to tilt the negotiations against you.

When picking mediators, solo and small-firm “Davids” should ask mediators, as part of their due diligence, whether those mediators employ processes such as these or instead hoard power over the negotiation. “Davids” cannot just ask the open-ended question, “Can you be fair to me and my clients?” Who would ever answer “no”? It would be as useless as the same question in jury voir dire. “Davids” should ask mediators for references to other solo or small-firm practitioners, to ask whether the mediator treated them fairly and respected their responsibilities toward their clients, or instead became “Goliaths.”

Solo and small firm “Davids” must guard their own roles in mediations jealously to ensure they retain the power necessary to discharge their fiduciary duty of undivided loyalty to their clients. To do this, they must conduct more lawyering tasks for their clients themselves.

**ENDNOTES**

Western National Mutual Insurance Company, Plaintiff, v. Prospect Foundry, Defendant

ORDER TO AMEND JUDGMENT

Court File No.: 27-CV-16-3476

APPEARANCES

This matter came before the Honorable Michael K. Browne, Judge of District Court, for a hearing on Defendant’s motion to amend/correct judgment and Plaintiff’s motion for a new trial on March 15, 2017. Mr. James Martin appeared on behalf of Plaintiff Western National Mutual Insurance Company (“Western National”). Mr. Christopher Yetka appeared on behalf of Prospect Foundry.

BACKGROUND

This matter came on for a trial by jury on January 11, 2017. At the conclusion of the trial, the jury found that:

1) Prospect Foundry did not breach the applicable worker compensation insurance contracts with Plaintiff, but found that Prospect Foundry should pay $101,407.64 to Western National to “fairly and adequately compensate” it in the case of breach. The jury did not fill out the question asking whether the breach of contract directly harmed Western National because it did not find that Prospect Foundry breached the contracts;
2) Western National breached the contract between the parties and that the breach resulted in damages to Prospect Foundry, but found that $0.00 would compensate Prospect Foundry for its damages; and

3) Western National breached the implied duty of good faith and fair dealing and that it owed Prospect Foundry $53,300.00 as a result of that breach.

**CONCLUSIONS OF LAW**

Plaintiff has moved the Court to either grant it a new trial or to issue a judgment as a matter of law. Defendant contends that the jury made correct findings, but that the judgment should be corrected. The Court finds that no new trial is needed and that a judgment as a matter of law is unnecessary. The Court finds that judgment should be amended to reflect the jury's factual findings.

I. **PLAINTIFF’S MOTION FOR A NEW TRIAL IS DENIED BECAUSE IT HAS NOT PROVIDED THE COURT WITH ADEQUATE EVIDENCE TO SHOW THAT THERE WAS IRREGULARITY, MISCONDUCT, ERROR, OR OTHER REASON TO CAST DOUBT ON THE JURY’S VERDICT.**

Minnesota Rule of Civil Procedure 59.01 provides that a court may grant a new trial to the parties in a case on all or part of the issues for any of the following causes:

(a) Irregularity in the proceedings of the court, referee, jury, or prevailing party, or any order or abuse of discretion, whereby the moving party was deprived of a fair trial;
(b) Misconduct of the jury or prevailing party;
(c) Accident or surprise which could not have been prevented by ordinary prudence;
(d) Material evidence newly discovered, which with reasonable diligence could not have been found and produced at the trial;
(e) Excessive or insufficient damages, appearing to have been given under the influence of passion or prejudice;
(f) Errors of law occurring at the trial, and objected to at the time or, if no objection need have been made pursuant to Rules 46 and 51, plainly assigned in the notice of motion;
(g) The verdict, decision, or report is not justified by the evidence, or is contrary to law; but, unless it be so expressly stated in the order granted a new trial, it shall not be presumed, on appeal, to have been made on the ground that the verdict, decision, or report was not justified by the evidence.

Minn. R. Civ. P. 59.01 (2017).

Plaintiff has made no showing of irregularity in the proceedings, misconduct by the jury or prevailing party, accident or surprise, or material evidence newly discovered. It argues that errors of the law occurred at trial that caused unfair prejudice, and that the jury’s verdict is not justified by the evidence at trial. It further argues that there was no evidence to support the damages that the jury awarded to compensate defendant for Plaintiff’s breach of the implied covenant of good faith and fair dealing.

A. *Errors of the Law*

A motion for a new trial should be granted rarely and cautiously, and only granted to further the administration of justice in the application of trial procedure. *Boland v. Morrill*, 132 N.W.2d 711, 720 (Minn. 1965). Plaintiff argues that the Court made the following errors of law during the trial: (1) instructing the jury wrongly on the definition of good faith, (2) instructing the jury that it may draw adverse inferences for failure to provide testimony, and (3) overruling and sustaining a variety of objections to testimony and evidence.
The Court’s instruction to the jury, based on CIVJIG 20.55, regarding the implied covenant of good faith and fair dealing read:

Under Minnesota law, every contract includes an implied duty of good faith and fair dealing. “Acting in good faith” means a person acts honestly in performing this part of the contract, whether it be negligently or not. Western National Mutual Insurance Company has a duty to act in good faith in the calculation of Prospect Foundry’s entitlement to dividend payments.


Plaintiff requested that the Court supplement this instruction, stating that a breach of an implied covenant of good faith and fair dealing requires that the conduct of one party, paired with an improper ulterior motive, unjustifiably hinder or obstruct the other party’s performance. Plaintiff cites Prairie Island Indian Community v. Minnesota Dept. of Public Safety for the proposition that “the covenant of good faith and fair dealing prohibits a party from ‘unjustifiably hindering’ the other party’s performance of the contract.” 658 N.W.2d 876 (Minn. Ct. App. 2003) (citing In re Hennepin County 1986 Recycling Bond Litig., 540 N.W.2d 494, 502 (Minn. 1995)).
However, this Court finds that while the implied covenant does, in fact, prohibit a party from unjustifiably hindering the other party’s performance of the contract – that is not all it prohibits. “[E]vasions of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of power to specify terms, and interference with or failure to cooperate in other party’s performance” are also breaches of the implied covenant. Restatement (Second) of Contracts § 205 (1981). See, for example, White Stone Partners, LP v. Piper Jaffray Companies, Inc., 978 F.Supp. 878 (D. Minn. 1997), Columbia Cas. Co. v. 3M Co., 814 N.W.2d 33 (Minn. Ct. App. 2012), Faricy Law Firm, P.A. v. API, Inc. Asbestos Settlement Trust, No. A16-1539, 2017 WL 1832415, at *5 (Minn. Ct. App. May 8, 2017) (unpublished) (stating, “[t]o prove a breach of the implied covenant of good faith and fair dealing, a party must prove that the other party acted in bad faith. ‘Bad faith’ is defined as a party’s refusal to fulfill some duty or contractual obligation based on an ulterior motive. A party to a contract does not act in bad faith by asserting or enforcing its legal and contractual rights.” (citations omitted)).

ii. The Court’s Instruction on Adverse Inferences.

Defendant requested that the following instruction be read to the jury, and the Court acquiesced:

If a party either:

1. Does not call a witness who has material evidence, or

2. Does not produce evidence that the party could reasonably be expected to produce, and fails to give a reasonable explanation, you may decide that the testimony or the evidence would have been unfavorable to that party.
Under Minnesota’s Jury Instruction Guide 12.35, the Committee on Civil Jury Instruction Guides stated, “[t]he Committee recommends no instruction.” 4 Minn. Prac. Jury Instr. Guides--Civil CIVJIG 12.35 (6th ed.). The Committee further stated, “[i]n the typical case, no instruction on this subject should be given.” Id. If counsel, in argument to the jury, misstates the law regarding the inference to be drawn, then an instruction may be given to the jury to weigh that evidence unfavorably against that party if the party fails to call a witness with material evidence or does not produce evidence that the party could reasonably be expected to produce. Id.

Upon review, the Court finds that it erred in reading the above instruction to the jury. There is no evidence that this case is anything but a “typical” contract dispute, and neither party alleges that the other party misstated the law to the jury. Yet, the Court must find that an error was prejudicial in order to grant a new trial based on that error. City of Moorhead v. Red River Valley Co-op. Power Ass’n, 830 N.W.2d 32, 39 (Minn. 2013). The moving party bears the burden of demonstrating the prejudicial error. Id.

Here, Plaintiff fails to show how the instruction is prejudicial to it, as the law requires that there not just be an error of the law, but that the error be prejudicial to the moving party. Plaintiff argues that the instruction permitted Prospect to argue that Western National’s failure to call Cassandra Rudy should be counted against it. Nevertheless, that argument was not contingent on the Court’s instruction, and the Court’s instruction allowed the fact that Ms. Rudy did not testify to weigh equally against the parties, who could have both subpoenaed her had she been integral to either case. Therefore, Plaintiff has not established prejudice resultant from the Court’s instruction.
iii. The Court’s Evidentiary Rulings.

A trial court may order a new trial if there were erroneous evidentiary rulings that were unfairly prejudicial to the party seeking a new trial. Kay Louise Stoebe v. Merastar Insurance Company, 554 N.W.2d 733, 735 (Minn. 1996). “Evidentiary rulings […] are within the broad discretion of the district court.” 830 N.W.2d at 39-40 (citing State v. Peterson, 764 N.W.2d 816, 821 (Minn. 2009)). The moving party bears the burden of demonstrating the prejudicial error. 830 N.W.2d at 39. Unless the moving party can demonstrate that the trial court “exercised its discretion arbitrarily, capriciously, or contrary to legal usage,” an appellate court is bound by the trial court’s evidentiary rulings. 830 N.W.2d at 40 (citing Kroning v. State Farm Auto. Ins. Co., 567 N.W.2d 42, 46 (Minn. 1997).

(a) Hearsay objections were properly overruled.

Mr. Mares’ statements were allowed in the record because they were statements of a party opponent. See Minn. R. Evid. 801(d)(2) (2006). Because Mr. Mares was Western National’s agent, he spoke as a party opponent under Minn. R. Evid. 801(d)(2)(C)-(D). Had the Court erred by accepting the testimony about his statements, its error was not prejudicial as Mr. Mares also testified, giving Plaintiff a chance to cure the evidence.
(b) **The evidence on the premiums paid was proper.**

Plaintiff argues that the Court should not have allowed testimony about Western National’s profit structure. However, this is disingenuous because the testimony was not only about the profit structure, but the premiums that Prospect Foundry paid. Minn. R. Evid. 403 provides that “[a]lthough relevant, evidence may be excluded if its probative value is substantially outweighed by the danger of unfair prejudice, confusion of the issues, or misleading the jury.” In this case, how much was charged in premiums was inextricably linked to the main issues of the case: whether the loss ratio as applied to the premiums paid qualified for dividends to be paid to Defendant.

Plaintiff argues that the evidence should have been excluded for its prejudicial effect. Minn. R. Evid. 403 provides that the possibility of prejudice “substantially” outweigh the relevance of the evidence. It is impossible to find that the evidence of the premiums paid, which is integral to the case, was irrelevant and/or was “substantially” outweighed by the general public’s alleged disaffection with regards to insurance companies. This is particularly true since trial record lacks any evidence of such sentiment against insurance providers. Moreover, Plaintiff has not demonstrated that the evidence is prejudicial, or that its admission was so against Plaintiff’s interests, as the same information is included in stipulated trial exhibits.
(c) **Mike Baumann’s expert testimony was proper.**

Plaintiff argues that Mr. Baumann’s testimony went beyond the expert witness disclosures provided by Defendant prior to trial. Mr. Baumann testified that the reduction of the reserves on the Andersen and Eilola claims should have occurred before June 1, 2013. In the pretrial disclosures, Defendant stated that Mr. Bauman would be testifying regarding “dividend calculations, application of the reserves and loss ratios… [as well as] Western National’s failure to properly apply loss ratio, reserves and premium reductions….” James Martin Aff., Ex. B at pp. 2-3, February 14, 2017, ECF No. 68. Mr. Baumann’s testimony regarding the timing of the reduction of the reserves falls under testimony about Western National’s failure to properly apply reserves. Therefore, the testimony was proper.

(d) **The Court properly disallowed Mr. Ellefson’s hearsay testimony.**

Plaintiff argues that the Court erred when it sustained Defendant’s hearsay objections to Mr. Ellefson’s testimony regarding how and why the claims were adjusted because, it says, Mr. Ellefson was an expert witness at trial and evidentiary Rule 703(a) allows for such testimony.

Minn. R. Evid. 801 defines hearsay as “a statement, other than one made by the declarant while testifying at the trial or hearing, offered in evidence to prove the truth of the matter asserted.” (2006). An expert witness may, under Minn. R. Evid. 703(a), speak about the facts or data upon which an expert bases his or her opinion. However, those facts and data are subject to the rules of hearsay, and must be independently admissible in order to be received upon direct examination. Minn. R. Evid. 703(b) (2006). In this case, Mr. Ellefson was attempting to relay the statements of his employees with regards to why they made particular decisions about the adjustments made. These statements were hearsay and therefore since they are not independently admissible, they are not allowed under Minn. R. Evid. 703(a).
(e) The Court properly disallowed Mr. Ellefson’s testimony on the legality of paying non-earned dividends.

Plaintiff argues that because Mr. Ellefson was an expert witness, he could testify as to the legal limitations on paying of a dividend, as well as statutory standards for writing or selling insurance. It contends that Mr. Ellefson was to testify with regards to why the insurance company would pay a “faux dividend” and Defendant’s sustained objection left the jury with no context for why Western National could not have tendered a dividend payment for the policy. The Court finds that the objection was properly sustained as Plaintiff’s disclosures regarding Mr. Ellefson’s testimony did not include his testimony on the legal or statutory regulations of the insurance industry. Further, this sustained objection to testimony alone is not grounds for a new trial, had it been in error, as Western National’s reasoning for its lack of payment could have been admitted into the record through a Marsh & McLennan employee, since the “faux dividend” concept was created by Marsh & McLennan. Had it been integral to Plaintiff’s case-in-chief or defense against the claim that Western National acted in bad faith, Plaintiff would have disclosed the testimony beforehand or have admitted it through another witness.

(f) The Court properly allowed Ms. Brophy’s testimony about why she left Western National Mutual Insurance Company.

Plaintiff called Ms. Brophy to the stand and Defendant asked her about her experience at Western National and why she left its employ. Plaintiff now claims that it is prejudicial to allow her to testify as to why she left Western National. The Court finds this argument insincere. It is natural, logical and relevant to pursue the line of questioning of any former employee of an organization as to why she left that organization, as her answer may have bearing on her credibility or the work about which she is testifying.
(g) Mr. Carlson’s testimony about the damages incurred by Defendant was properly allowed.

Plaintiff argues that Mr. Carlson’s testimony on his time spent on dealing with the problems with Plaintiff should had been disallowed because Mr. Carlson is not personally a party to this action and because it was outside the scope of the pleadings. However, Mr. Carlson is President of Defendant. Mr. Carlson stated that the time he spent dealing with the insurance issue was directly pulled from the time he would have otherwise spent on normal company business.

Further, these damages were not outside the scope of the pleadings. In any case in which there is a breach of contract claim, there is a claim for damages that result from the breach, or consequential damages. Consequential damages “are injuries to person or property proximately resulting from the breach.” 318 N.W.2d 50 (Minn. 1982) (citing MINN. STAT. § 336.2–715(2)(b) (1980)). The damages incurred by Defendant in the form of Mr. Carlson’s time are foreseeable damages, as it is clear that if there is a discrepancy in dividend payment to the tune of $59,000, a company representative, or representatives, would have taken time to sort the issue out.
B. Evidence for the Jury’s Findings at Trial.

Significantly, Plaintiff argues that the jury’s findings are not supported by the facts presented at trial. A jury’s answer to a special verdict form can be set aside by a trial court only if no reasonable mind could find as the jury found. *Domtar, Inc. v. Niagara Fire Ins. Co.*, 563 N.W.2d 724, 735 (Minn. 1997). When reconciling these answers, the court should liberally construe the special verdict form to give effect to the jury’s intention. *Dunn v. National Beverage Corp.*, 745 N.W.2d 549, 555 (Minn. 2008). Additionally, the evidence should be considered in the light most favorable to the prevailing party, which in this case is Prospect Foundry. *See Stumne v. Village Sports & Gas*, 243 N.W.2d 329, 330 (Minn. 1976). The Court finds that the jury’s findings are well supported by trial evidence.

i. Evidence of no Breach by Prospect

The jury found that Defendant did not breach the contract between the parties. Its finding of no breach is consistent with the testimony at trial. Trial testimony showed that Defendant continued to pay its due premiums until the determination by Western National on June 1, 2012, that Defendant would not be receiving dividends. Under Minnesota law, a party who first breaches a contract cannot use the other party’s subsequent breach to avoid liability. *Space Ctr, Inc. v. 451 Corp.*, 298 N.W.2d 443,451 (Minn. 1980).
The Court of Appeals of Minnesota held that a first breaching party could not sue on the basis of the other party’s subsequent breach because: (1) the initial breach was continuing at the time that the first breaching party brought the action against the subsequent breacher, and (2) the subsequent breach resulted directly from the first breach. *Carlson Real Estate Co. v. Soltan*, 549 N.W.2d 37g, 380 (Minn. Ct. App. 1996) (citing *MTS Co. v. Taiga Corp.*, 365 N.W.2d 321 (Minn. Ct. App. 1985) *review denied* (Minn. June 14, 1985)). Here, the jury found that Western National breached the contract by failing to close the two errant claims and paying Prospect its due dividend. Since Western National did not paid the dividend, Prospect stopped paying its premiums as a result of Western National’s nonpayment. As a result, Prospect is not the non-compliant actor when the jury found that Western National was the original party to breach the contract.

**ii. Evidence of Breach of Contract and Implied Covenant by Western National.**

At trial, Defendant provided evidence that the Anderson and Eilola claims were over-reserved and not closed in a timely manner.

Mr. Carlson and Mr. John Mares provided conflicting testimony regarding what Mr. Mares told Mr. Carlson about the reserves and closing the open claims. Mr. Carlson testified that he told Mr. Mares that the Anderson and Eilola claims were resolved and should be closed and Mr. Mares told him that would be done before the June 1, 2012 date. He also testified that Mr. Mares told him that the person in charge of his claims was on vacation and that was the reason for the untimely claim closure. Mr. Mares denies both these allegations, and denies that he told Mr. Carlson that he could resolve or adjust any of the claims. The jury found Mr. Carlson credible, as found in their special verdict form answers and in the adaptation of Mr. Carlson’s mathematical computations.
Additionally, defense expert Mr. Mike Baumann provided testimony that the reserves on the Anderson file were grossly overstated and that the Eilola claim should have been closed as of June 1, 2013. Ms. Janet Brophy testified that there was an error in the timing of the claim being closed or the reserve reduced, and that she could think of no reason to preclude correction of that error. In addition, Mr. Carlson testified that each time he would receive a proposal from Western National, he would spend time trying to figure out how the numbers were reached but was unable to decipher Mr. Ellefson’s calculation. In fact, Mr. Ellefson himself testified that his computations were fluctuating and different calculations that he reviewed and approved yielded different numerical outcomes, even during testimony at trial.

These changing numbers and testimony were sufficient for the jury to find that Western National failed to close the claims and reduce reserves in a timely way in violation of industry standards.

It is clear that the jury found Mr. Carlson and Mr. Baumann credible. The special verdict form responses directly mirror their testimony. Because the jury’s findings on these claims are consistent with the testimony presented, coupled with the fact that it comports with a viable legal theory, the Court finds that the Plaintiff’s claim that inconsistency of the jury’s verdict with trial evidence is not a sound basis upon which to grant Plaintiff’s motion for a new trial.
C. **Damages for the Implied Covenant of Good Faith and Fair Dealing.**

Plaintiff argues that there was insufficient evidence at trial to find the $53,300 in damages that the jury granted Defendant. Mr. Carlson testified as to the damages his company incurred as a result of his time spent negotiating this matter with Plaintiff. He was specific and stated that the cost to Prospect of his time was $205 per hour. He stated that he spent 25 hours each in 2013 and 2014 on this matter, as well as 50 hours in 2015, 120 hours in 2016, and 40 hours in 2017. Mr. Carlson’s testimony included specific and measured estimation of his damages, and is evidence to the jury when calculating damages.

Plaintiff argues that the damages found by the jury were not sufficiently and specifically found in the pleadings. However, Plaintiff received Defendant’s counterclaim on March 25, 2016, and did not argue the lack of specificity of the claims until the motion at bar. Plaintiff further argues that special damages cannot be awarded if general damages are not awarded. This is only true when the jury is giving damages for breach of contract, and it is not a rule for breach of the implied covenant of good faith and fair dealing. No award was given to Defendant on Plaintiff’s breach of contract claim, but an award was given for the breach of the implied covenant action, which was intended to be full compensation for Defendant’s losses.
II. PLAINIFF’S MOTION FOR JUDGMENT AS A MATTER OF LAW IS DENIED BECAUSE IT IS CLEAR THE JURY BELIEVED THE TESTIMONY OF MR. DARRIN CARLSON AND FOUND THAT PLAINTIFF BREACHED THE CONTRACT; AND DEFENDANT’S MOTION FOR A CORRECTED JUDGMENT SHALL BE GRANTED BECAUSE, UPON REVIEW, THE COURT FINDS THAT THE JURY DID NOT SEEK TO PROVIDE BREACH OF CONTRACT DAMAGES TO PLAINIFF.

Judgment as a matter of law is appropriate where a jury verdict has no reasonable support in fact or is contrary to law. Longbehn v. Schoenrock, 727 N.W.2d 153, 159 (Minn. Ct. App. 2007). For such a judgment, courts must view the evidence “in the light most favorable to the nonmoving party and determine whether the verdict is manifestly against the entire evidence or whether despite the jury’s findings of fact the moving party is entitled to judgment as a matter of law.” Navarre v. S. Washington County Schs., 652 N.W.2d 9, 21 (Minn.2002). The jury’s verdict will only be set aside if it cannot be sustained by any theory of the evidence. Longbehn, 727 N.W.2d at 159, citing Pouliot v. Fitzsimmons, 582 N.W.2d 221, 224 (Minn.1998).

As analyzed above in Section III(B)(i)-(ii), there is ample evidence to support the jury’s findings that Plaintiff breached the contract, that Defendant did not breach the contract, and that Plaintiff breached the implied covenant of good faith and fair dealing. The jury filled out the special verdict form as instructed by it, and the Court previously erred in its adoption of the jury’s findings. It is clear to the Court that the jury found Mr. Carlson and Mr. Baumann credible and rooted its verdict form responses in their testimony.
In Question 1, the jury found that Defendant did not breach the applicable insurance contracts. In Question 2, the form asks whether the breach that may be found in Question 1 resulted in damage. Since there was no breach, the jury moved onto Question 3 (which was the correct action to take according to the instructions). Before Question 3, the verdict form states, “Answer the following question regardless of your answers to the previous questions.” Question 3 asked, “What amount of money will fairly and adequately compensate Plaintiff for its damages?” The jury responded that, had Defendant breached, Plaintiff would be compensated with $101,407.64 in damages, which was the amount Prospect recognized at trial as the most it would have owed Plaintiff if found in breach. Despite the fact that the jury wrote an amount in this line, it was merely following the directions of the form and did not intend for the Court to grant the amount to Plaintiff in an award.

The jury went on to find in Questions 4-6 that Plaintiff was in breach of the contract, and caused damage to Plaintiff, and that $0.00 would be required to compensate it for its damages. The jury may have chosen to give Defendant no damages for the breach of contract to avoid granting Defendant a windfall. It likely determined that no damages were needed to make Defendant whole on this breach of contract claim since it was granting a monetary award for the implied covenant claim.

Finally, in Questions 7-9, the jury found that Plaintiff breached the implied covenant, that the breach resulted in damages, and that an award of $53,300 in damages would compensate Defendant. This number is the amount Mr. Carlson declared would compensate Defendant for the hours he worked dealing with Western National’s breach. It is clear to the Court, upon review, that the jury’s damage awards are consistent with the testimony and its response sought to grant a damages award to Defendant alone.
CONCLUSION

Plaintiff failed to demonstrate a sound reason for the Court to grant it a new trial or to dismiss the jury’s findings. The Court’s evidentiary objections are well within its purview and rely on sound legal analysis. Although the Plaintiff’s objections to the jury instructions are partially sound, Plaintiff failed to show prejudice as a result of the instructions. Finally, the jury’s verdict was supported by the evidence presented at trial. For these reasons, the Court declines Plaintiff’s motion for a new trial or grant its motion for a judgment as a matter of law. Defendant’s motion for a corrected judgment is granted because, upon review, the Court found that it erred when adopting the jury’s findings in its January 24, 2017 Order for Judgment.

ORDER

Based on the arguments and facts presented during trial, in the parties’ filings, and during oral argument, the Court HEREBY ORDERS THAT:

1. Plaintiff’s motion for a new trial is DENIED.
2. Plaintiff’s motion for judgment as a matter of law is DENIED.
3. Defendant’s motion to amend the judgment is GRANTED.
4. The Court shall revise its January 24, 2017, Order for Judgment as follows:
   a. Judgment in the favor of Plaintiff Western National in the amount of $101,407.64 SHALL BE VACATED.
   b. Judgment SHALL BE ENTERED ONLY in favor of Defendant Prospect Foundry in the amount of $53,300 for Plaintiff’s breach of the implied covenant of good faith and fair dealing.

THERE BEING NO JUST REASON FOR DELAY, LET JUDGMENT BE ENTERED ACCORDINGLY.

BY THE COURT

Browne, Michael
Judge of District Court
06/13/17 4:36 PM
D&O Potpourri—Current & Trending
Issues in D&O Coverage

27th Annual ABA/TIPS Insurance Coverage Litigation Committee
Midyear Conference
February 21-23, 2019
Arizona Biltmore Resort & Spa
Phoenix, Arizona
Panelists:  Ted Carleton, Principal, Skarzynski Black LLC, New York, NY
          John Favilla, AVP, Berkley Professional Liability, New York, NY
          Ari Magedoff, AVP, Axis Capital, New York, NY
          Helen Michael, Partner, Kilpatrick Townsend LLP, Washington, D.C.

Moderator:  Janet Davis, Shareholder, Cozen O'Connor, Chicago, IL

*Any opinions expressed in this paper are not the opinions of any individual speaker and/or their employers.
D&O Potpourri—Current & Trending Issues in D&O Coverage

2018 saw a wide variety of issues develop in the world of management liability insurance and claims against directors and officers. This review will focus on a few of the key areas—the increased frequency of securities claims, the potential impact of the Restatement of the Law of Liability Insurance, the #MeToo movement, cyber/data breaches, and date of claim issues—but there are many others. For instance, the emergence of event-driven securities litigation, in addition to cases based on sexual misconduct, is playing a significant role in the increase in securities litigation. Unlike traditionally-based cases related to financial or accounting misrepresentations, event-driven securities litigation can involve data breaches, explosions (e.g. mines, Deepwater Horizon), product failure (e.g. Zicam Cold Remedy), federal raids/investigations, product failures (e.g. Grenfell Tower fire and Johnson & Johnson baby powder) and climate change including the California wildfires. Climate change as a management liability issue also appeared in an action filed by the New York Attorney General against ExxonMobil alleging systematic and repeated efforts to deceive investors about the future impacts that climate change regulation could have on the company’s value. Corporate disclosure claims relating to climate change and the resulting exposures to companies and their management is clearly another trending issue in the D&O world but has not yet reached the level of attention of the areas addressed here.

For a great review of current and trending issues in the D&O industry, take a look at “What to Watch Now in the World of D&O” (The D&O Diary, September 4, 2018). Also available is “The Year in Review: 2018 Key D&O Insurance Coverage Decisions” (The D&O Diary, January 14, 2019). Attached with the gracious permission of Kevin LaCroix, author of The D&O Diary, are a number of other posts from this go-to blog for the D&O industry which are just a sampling of those published in the past year on the topics included below. Many more posts are available on all of the trending issues noted above as well as those on the issues selected for discussion. The selected (and attached) posts start with a great overview, “The Top Ten D&O Stories of 2018.”

Increased Frequency of Securities Litigation

Two of the key resources for following securities class action litigation, NERA Economic Consulting and Cornerstone Research, both reported high levels of filings in 2018. NERA’s 2018 report notes the following highlights:

- The highest number of securities class action cases filed in federal courts since the aftermath of the 2000 dot-com crash.
- The second consecutive year in which a record number of cases concluded.
- Median settlement ($13 million) more than twice that of 2018 due to higher settlements of moderately sized cases and fewer very small settlements.
- Aggregate investor losses (as defined by NERA) were a record $939 billion, nearly four times the preceding five-year average.
- Aggregate plaintiffs’ attorneys’ fees and expenses were $790 million, 70% higher than 2017.

Cornerstone’s press release regarding its 2018 report points to these key trends:

- The number of mega Maximum Dollar Loss filings (MDL of at least $10 billion) and mega Disclosure Dollar Loss filings (DDL of at least $5 billion) increased dramatically in 2018.
- Core filings against non-U.S. companies fell for the first time since 2013.
- Core filings against biotechnology, pharmaceutical, and healthcare companies declined from 66 in 2017 to 56 in 2018, yet remained above historical averages.
- Core filings against technology and communications sector filings increased.
- Ninth Circuit core filings reached historic levels.
- Plaintiffs filed nine lawsuits related to initial coin offerings or cryptocurrency in 2018, up from five in 2017. However, eight were filed in the first half of 2018 and only one in the second half, as ICO markets began to cool in 2018.

“Securities Class Action Filings Remain Near Record High in 2018,” (www.cornerstone.com, January 30, 2019). This summary of the full Cornerstone report, “Securities Class Action Filings: 2018 Year in Review,” also highlights the significance of Cyan Inc. v. Beaver County Employees Retirement Fund, 583 U.S. ___, 2018 WL1384564, (March 20 2018) in which the U.S. Supreme Court issued a unanimous opinion allowing plaintiffs to assert claims under the Securities Act of 1933 (1933 Act) in state courts. Under the 1933 Act, Section 11 allows investors to pursue damages for alleged misrepresentations or omissions in securities registration statements. Although state court filings are more difficult to track than federal filings, the Cornerstone report finds that state court securities lawsuit filings drove securities class action litigation filing to arguably the highest levels ever and estimates that these filings represent an aggregate market capitalization loss of over $1 trillion.

For a further review of the trends in securities filings and the impact of state court filings, go to the attached posts “Securities Suit Filings Continued at Heightened Pace in 2018” and “Section 11 Claims May Remain in State Court; How Will Companies and D&O Carriers Respond?” Trends to note are that while filings are higher, there is a continued reduction in the more traditional securities class action cases related to financial or accounting misrepresentations which is likely related to fewer corporations announcing financial restatements. While financial misrepresentation case numbers are down, merger objection lawsuit filings continue to rise with this category of cases rising to 48% of the filings in 2018. And, as noted above, event-driven securities litigation may represent the most significant trend in this arena.

The Restatement and D&O Coverage Implications

Given that the Restatement of the Law of Liability Insurance was only formally adopted in May 2018, it has yet to be analyzed extensively by courts and legal scholars. In particular, there is a dearth of commentary addressing the Restatement’s impact on D&O policies. Legal scholars that have considered the Restatement as it pertains to claims-made insurance policies generally have focused on the Restatement’s treatment of: (a) an insured’s reporting requirement as a condition subject to the notice prejudice rule under certain circumstances, rather than as an element of coverage; and (b) the circumstances under which an insurer may rely on extrinsic evidence to deny a duty to defend. E.g., Going Beyond the Four Corners to Deny A Defense: A Critique of Section 13(3) of the Restatement of Liability Insurance, 53 Tort Trial & Ins. Prac. L.J. 795, 800 (Spring/Summer 2018); From Principles to Restatement: The Impact of The American Law Institute’s Restatement, Law of Liability Insurance on American Insurance Law, 39 No. 6 Insurance Litigation Reporter NL 1 (April 2017).
At least three courts have cited draft versions of the Restatement in addressing D&O coverage disputes. The results are mixed. In Morden v. XL Specialty Ins., 177 F. Supp. 3d 1320 (D. Utah 2016), a federal district court approvingly quoted a draft of the Restatement to note that it is common for D&O insurers to pay for costs of defense without taking on the duty to defend, and that such arrangements do not impose fiduciary obligations on the insurer. The court went on to reject the insureds’ argument that the insurer acted in bad faith and breached its fiduciary duty to settle the underlying claim. Morden, 177 F. Supp. 3d at 1340-42, aff’d in part, rev’d in part and remanded, 903 F.3d 1145 (10th Cir. 2018). However, in Outdoor Venture Corp. v. Philadelphia Indem. Ins. Co., No. 6:16-CV-182-KKC, 2018 WL 4656400, at *18 (E.D. Ky. Sept. 27, 2018), the district court considered and rejected the insureds’ argument that their insurers should be required to provide independent counsel based on a provision in the draft of the Restatement stating that when “there are facts at issue that are common to the legal action for which the defense is due and to the coverage dispute, such that the action could be defended in a manner that would benefit the insurer at the expense of the insured, the insurer must provide an independent defense of the action.” The court concluded that Kentucky law is clear that an insurer need not obtain independent counsel whenever “there is a potential conflict between a coverage issue and the merits of the underlying litigation.” Id. at *19. More recently, an Illinois state court, citing the Restatement, held that there is no common law right to recoupment under a D&O Policy absent express contractual language providing for such relief. See, Gilbane v. Liberty Insurance Underwriters, Cook County Illinois, Nov. 2, 2018.

#MeToo—D&O Claims Based on Alleged Sexual Misconduct

The term “Me Too” was first used by Tarana Burke in 2006 as a way to help women and girls of color who had survived sexual violence. Obviously, she had no idea that the phrase would become a slogan of the anti-sexual harassment movement in 2017. While most know about the salacious allegations against those in entertainment and politics, the #MeToo movement had a significant impact on corporations and the insurance world in 2018, not only with respect to D&O coverage but other lines of coverage including EPL and GL have been impacted as well. Coverage issues have arisen not only as to the scope of potential coverage under the various types of policies but also regarding the interaction of the coverages potentially available. An excellent review of D&O coverage for these types of claims is “#MeToo and the Emerging D&O Risks: Corporate D&O Liability and Sexual Harassment in the Workplace.” Biging and Zimmer, The Brief, Fall 2018.

Included here are the following posts on this topic from The D&O Diary—“Alphabet Board Hit With Derivative Suits Over Alleged Misconduct at Google” (January 13, 2019), “Dismissal Motion Denied in Sexual Misconduct-Related Securities Suits” (December 12, 2018), and “Nike Board Hit with Sexual Misconduct-Related Derivative Suit” (October 30, 2018). These are just a few of the actions filed against corporations and their boards over the past year. Other notable corporate defendants are Wynn Resorts, National Beverage Corporation, CBS, Papa John’s, Teladoc Health, and 21st Century Fox which was one of the earliest corporate defendants in a sexual misconduct-related derivative case that settled in 2018 for $90 million reportedly funded by the company’s D&O insurers. The 21st Century Fox case was a derivative action but others, such as the case against Signet Jewelers (discussed in the December 12, 2018 post noted above) are filed as securities class actions. While the early cases resulting from the #MeToo movement were efforts to hold wrongdoers liable, the cases against corporations and their boards seek to hold boards and corporate management who permitted the behavior or turned a blind eye responsible.
The most recent cases against a major publicly traded company are two derivative actions against the board of Alphabet based on allegations of alleged sexual misconduct at the company’s Google unit. *Northern California Pipe Trades Pension Plan v. Hennessey*, San Mateo Superior Court, (January 9, 2019) and *Martin v. Page*, San Mateo Superior Court, (January 10, 2019). As reported in *The D&O Diary*, both actions assert claims for breach of fiduciary duty, unjust enrichment, and corporate waste. The complaints allege a “culture of concealment” relating to “a long-standing pattern of sexual harassment and discrimination by high-powered male executives.” The complaints assert that the “pattern of concealment” was “intended to protect the Company’s top earning executives and the Board.” These actions were fueled by articles in the *New York Times* (October 25, 2018) and the *Wall Street Journal* (November 1, 2018) which reported that credible allegations against senior Google executives did not result in firing for cause but rather in “significant and wasteful exit packages” which hid the “true reasons for their departure.” These reports led to a mass walkout of Google employees worldwide on November 1, 2018. The complaints allege extreme conduct including human trafficking and that the board was “directly involved in and approved” the severance packages and made a “conscious and intentional decision to conceal the sexual harassment at Google.” In addition to allegations of sexual misconduct, the Alphabet/Google litigation also references a data privacy breach and that the board “hid the breach from the public and from Alphabet shareholders.”

**Cyber/Data Breach Claims**

Whether data breach/privacy claims against corporations and their boards are filed as stand-alone actions or combined with other allegations of misdeeds such as the Alphabet/Google case discussed above, there is no question that we are only beginning to see the scope of cyber, data breach, and privacy-related exposures to corporations and their boards and the resulting impact on the insurance industry. The Yahoo data breach alone resulted in an $80 million settlement of securities litigation and a $29 million settlement of a derivative suit. See, “Yahoo Settles Data Breach-Related Securities Suit for $80 million” and “Yahoo Data Breach-Related Derivative Suit Settled for $29 Million” (attached). Another settlement of a data breach-related derivative case in 2018 was the Wendy’s settlement. The Wendy’s settlement, however, was quite different. There were no payments to the company but the company agreed to adopt a number of different cybersecurity measures and protocols and establish a board-level oversight committee. The only payment in the Wendy’s settlement was $950,000 to the plaintiffs’ attorneys which was funded by Wendy’s D&O insurers.

Although very popular with the plaintiffs’ bar, not all data breach cases are so successful. See, “Dismissal Motion Granted in PayPal Data Breach-Related Securities Suit” (attached). However, we should expect these lawsuits to continue. The day after Marriott announced the Starwood data breach, a securities class action case was filed. See, “Marriot Hit with Data Breach-Related Securities Lawsuit” (attached). Google+ is now facing user data litigation on both coasts related to its failure to disclose user data exposure when first identified. The subsequent disclosure resulted in a stock drop which drew the securities class action lawsuits.

The SEC issued guidance in February 2018 for cybersecurity disclosures. While the “guidance” has been criticized for its lack of actual helpful suggestions, it does recognize that cybersecurity disclosures are encompassed in the existing laws and requirements and states that companies should “take all required actions to inform investors” about all cybersecurity risks and incidents in a timely fashion. The SEC subsequently levied a $35 million penalty in April 2018 against Yahoo’s successor in interest for Yahoo’s two-year delay in reporting a massive data breach in December 2014. This is yet another big number
associated with the Yahoo data breach in addition to those paid in settlement of securities and derivative litigation as noted above.

Of course, where there are large payments, there are likely to be coverage questions. The relationship between some potential coverages for cyber issues is discussed in another paper in these conference materials, “Cyber & Network Interruption vs. Business Interruption Coverage Overlaps and Gaps.” There have not been many reported cases involving cyber policies but those limited cases and others addressing whether more traditional policy forms will respond to cyber-related claims are discussed in an article by Peter Selvin. “Courts Wrestle With Coverage for Cyber-Related Claims,” The D&O Diary, October 16, 2018.

Date of Claim Issues

Given the broadening of D&O coverages generally, one of the last hotly disputed coverage limitations concerns date of claim/policy placement issues. The notion that a single lawsuit may contain multiple claims triggering multiple policy periods is anathema to the underwriters of claims made coverage, a product designed to limit loss to a single year of account. However, advocates on both sides of the fence have advanced arguments both for and against claim aggregation, in an attempt to maximize or restrict coverage as the case may be. Current hot topics include whether qui tam suits filed under seal can be deemed related to later filed civil litigation, what is the threshold standard for finding claims are related and should therefore be aggregated, and whether regulatory proceedings consist of multiple claims.

Conclusion

As noted at the outset, the mix for this D&O potpourri reflects only some of the trending issues in the D&O market and D&O coverage. What it does highlight is the extent to which claims against corporations and their officers often reflect issues in the news as well as societal trends.
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“Section 11 Claims May Remain in State Court; How Will Companies and D&O Carriers Respond?” (January 15, 2019)

“Alphabet Board Hit With Derivative Suits Over Alleged Sexual Misconduct at Google” (January 13, 2019)

“Dismissal Motion Denied in Sexual Misconduct-Related Securities Suit” (December 12, 2018)

“Nike Board Hit with Sexual Misconduct-Related Derivative Suit” (October 30, 2018)

“Yahoo Settles Data Breach-Related Securities Suit for $80 million” (March 5, 2018)

“Yahoo Data Breach-Related Derivative Suit Settled for $29 Million” (January 21, 2019)

“Dismissal Motion Granted in PayPal Data Breach-Related Securities Suit” (December 18, 2018)

“Marriott Hit with Data Breach-Related Securities Lawsuit” (December 3, 2018)
The Top Ten D&O Stories of 2018

By Kevin LaCroix on January 7, 2019
Posted in Director and Officer Liability

The world of directors’ and officers’ liability is always dynamic, but 2018 was a particularly eventful year in the D&O liability arena. The past year’s many developments have significant implications for what may lie ahead in 2019 – and possibly for years to come. I have set out below the Top Ten D&O Stories of 2018, with an eye toward future possibilities.

1. Securities Class Action Lawsuit Filings Remain at Near-Record Levels

The number of securities class action lawsuit filings remained close to record levels in 2018. There were 403 new federal court securities class action lawsuit filings in 2018. While the number of filings in 2018 was slightly below the 412 federal court securities suit lawsuits filed in 2017 (representing a decline of about 2%), the 2018 filing total is nearly 210% above the 1996-2016 average annual number of filings of 193.

As has been the case in the most recent years, a significant factor in the heightened level of securities lawsuit filings during 2018 was the number of federal court merger objection suits filed as class action lawsuits under the federal securities laws. In 2018, there were 185 merger objection lawsuits filed in federal court, representing about 46% of the federal court securities class action lawsuit filings.

However, even disregarding the merger objection lawsuits, the 2018 filings were significantly elevated compared to long-term averages. Of the 403 securities lawsuit filings in 2018, 218 were “traditional”
securities class action lawsuit filings, which is nearly 13% above the 1996-2016 annual average number of filings (193).

Although the number of 2018 federal court securities class action lawsuit filings is near record levels, the tally may in fact underrepresent the level of securities class action litigation activity during the year. In March 2018, the U.S. Supreme Court held in the Cyan case that state courts retain concurrent jurisdiction over liability actions under the Securities Act of 1933. This statutory liability primarily affects IPO companies. As discussed further below, following the Cyan decision, plaintiffs’ lawyers filed a significant number of state court securities class action lawsuits against IPO companies. Some of these state court actions do not have parallel federal court actions. The state court actions are much harder to track than federal court actions. In the absence of complete and accurate information on state court securities litigation filings activity, the federal court-only tally arguably underrepresents the level of securities class action activity during the year.

While the number of lawsuits filed is of course significant, the rate of litigation — that is, the number of lawsuits relative to the number of listed companies — represents an even more meaningful comparison. The litigation rate has been increasing in recent years as the number of lawsuits has increased while the number of listed companies has decreased (owing to bankruptcy, mergers, and going private transactions).

Of the 403 defendant companies hit with securities suits in 2018, 385 are listed companies, which implies (using the 2017 year-end number of listed companies of 4,411) a litigation rate of 8.7%, the highest rate since at least 1996. In other words, the likelihood of a listed company getting hit with a securities suit arguably was higher in 2018 than it has even been. Even if the merger lawsuits are taken out of the equation, the litigation rate calculates to 4.6%, which is also the highest-ever level.

In addition to the merger objection lawsuits, there are several other factors that drove the increased level of litigation in 2018. One was the continued emergence of event-drive securities litigation, which is discussed further below. Other factors contributing to the heightened filings levels include the increased prevalence of securities class action litigation filed in the wake of a data breach disclosure and the rise of securities suits based on privacy-related concerns, both of which are also discussed below. Another
factor is the rise in the number of securities suits relating to revelations of sexual misconduct, a topic that is also discussed below.

Looking ahead, there is every reason to expect that the elevated levels of securities class action activity will continue. Much of the activity in 2017 and 2018 was driven by the hyperactivity of a very small number of so-called “emerging” plaintiffs' law firms, and there is every sign that these law firms will continue to pursue this active approach during 2019.

The significantly elevated level of securities class action activity is a serious problem both for publicly traded companies and for their insurers. The increased likelihood of a listed company getting hit with a securities suit is a significant threat for public companies. For their insurers, the heightened threat of securities litigation represents a significant challenge in an environment where abundant insurance capacity provides a check on any attempts to seek rate increases.

2. IPO Companies Face State Court Securities Lawsuit Risk

As noted in the preceding section, on March 20, 2018, the U.S. Supreme Court issued its unanimous decision in *Cyan, Inc. v. Beaver County Employees Retirement Fund*, holding that state courts retain concurrent jurisdiction with federal courts for liability actions under the Securities Act of 1933. The immediate practical consequence of this decision is that if a company is hit with a '33 Act securities lawsuit in state court, the company can’t remove the state court lawsuit to federal court even if there is a parallel or even identical federal court action.

IPO companies now face the possibility of having to fight securities litigation in multiple jurisdictions. Indeed, IPO companies face the possibility not only of having to litigate claims in both state and federal court, but also face the possibility of having to litigate in multiple state courts at the same time.

When parallel cases are pending in both state and federal court, there is no procedural mechanism to consolidate or coordinate the cases. So unless one of the courts involved is willing to stay its proceedings
in deference to the other court, both cases will go forward at the same time. The possibility of multi-jurisdiction litigation not only presents the prospect of increased attorneys’ fees as the defendant company is forced to fight a multi-front war, but it also presents the risk of logistical and procedural issues that could complicate the company’s defense. The overall prognostication is for more complicated and more costly IPO-related litigation.

It has only been a few months since the Cyan decision was handed down and there are not yet complete statistics showing how frequently IPO companies have been sued in state court or in both state and federal court, but there are several examples where IPO companies have been hit with separate lawsuits filed in state and federal court. For example, GreenSky, Inc., a fintech company that completed its IPO in April 2018, was first sued on November 17, 2018 in New York state court, and then on November 28, 2018, the company was sued in federal court in New York. Loma Negra Compania, an Argentinian construction company that listed its securities in the U.S. in November 2017, was sued in New York state court in June 2018, and was sued in New York federal court in December 2018.

By my informal and unaudited tally, during 2018, there have been as many as eleven Section 11 class actions filed in California state court and nine filed New York state court, most of also involve pending parallel federal court lawsuits. (Please note that these California and New York state court filing figures almost certainly are incomplete.) However, in both jurisdictions there are new Section 11 class action lawsuits that do not have parallel federal court lawsuits. In addition to California and New York, there also have been Section 11 lawsuits filed in state courts in Colorado, Texas, Massachusetts, and Tennessee, among other states.

Although much of the discussion about Cyan and its impact has focused on IPO companies, companies that conduct secondary offerings also incur potential liability under the ’33 Act. As a result of Cyan, a company sued for alleged misrepresentations in connection with a secondary offering could also face the possibility of having to litigate in multiple forums.

Companies involved in merger transactions that face merger objection litigation presenting claims under the ’33 Act could also face the risk of multi-jurisdiction litigation; indeed, as discussed here, there
have already been several state court merger objection lawsuits filed under the '33 Act, including at least one instance where there were actions filed in two different states.

One idea that has been circulating since even before the Supreme Court issued its decision in Cyan is that companies can adopt a bylaw specifying that all claims under the Securities Act of 1933 must be filed in federal court. As discussed here, a shareholder of Blue Apron, Stitch Fix and Roku (all recent IPO companies) filed an action in Delaware Chancery Court seeking a judicial declaration that the companies’ bylaws designating a federal forum for securities lawsuits are invalid and unenforceable. As discussed here, on December 19, 2018, Vice Chancellor Travis Laster issued a memorandum opinion agreeing with the plaintiff and holding that under Delaware law, Federal Forum Provisions are invalid and ineffective.

Because so many publicly traded companies are organized under the laws of Delaware, including most IPO companies, Vice Chancellor Laster’s ruling effectively eliminates the possibility of using Federal Forum Provisions for most companies. The bottom line is that IPO companies and other companies now continue to face the possibility of having to fight Section 11 litigation in state court, possibly as part of a multi-front war.

The D&O insurers have been trying to find an equilibrium solution to these issues, particularly for IPO companies. Many insurers will now only quote primary D&O insurance for an IPO company subject to a separate retention for state court securities lawsuits, and in some cases also subject to coinsurance. The retentions range as high as $10 million or more. (It is not entirely clear how this retention would work in the event of parallel state and federal litigation.) However, there are also carriers willing to quote D&O for IPO companies without a separate state court securities litigation retention. In any event, the cost of D&O insurance for IPO companies is higher than in the past, in many cases significantly so. As the litigation experience with these kinds of lawsuits develops, the insurers’ response is likely to evolve as well.

3. Event-Driven Securities Suits Represent a Serious and Growing Problem
There was a time in the not-too-distant past when securities lawsuits were primarily about financial or accounting misrepresentations. However, in recent years, the number of companies announcing financial restatements has declined; in 2017, the number of restatements hit a 17-year low. With fewer accounting scandals to try to exploit as the basis for securities lawsuits, the plaintiffs’ lawyers (or at least some of them) apparently changed their business model. A small group of plaintiffs’ lawyers now seem increasingly focused on pursuing securities suits filed against companies whose share prices have declined following a significant disruptive event in the company’s operations. These kinds of event-driven lawsuits were a significant factor in the heightened level of securities class action filings in 2018.

Here are just a few of the 2018 event-driven securities class action lawsuit filings: In November, after the devastating California wildfires, plaintiff shareholders filed securities lawsuits against Edison International and, separately, against PG&E after news reports that the company’s facilities may have caused the wildfires; also in November, a plaintiff shareholder filed a securities suit against Boeing after one of its planes was involved in the Lion Air Flight 610 air disaster; in December, one day after Marriott announced a massive data breach involving its Starwood division, a plaintiff shareholder filed a class action lawsuit against the company and certain of its executives. (The wildfire lawsuits and the data breach lawsuit are discussed further below.)

The events behind these recently filed securities class action lawsuits represent a broad range of circumstances. What these lawsuits have in common is that none of them involve alleged accounting misrepresentations; instead, what they involve significantly negative events arising out of the company’s business operations that caused the company’s share prices to decline.

There are a few other things that these event-driven lawsuits have in common. Among other things, they are almost always filed by the same small group of plaintiffs’ law firms, a group that has been euphemistically referred to as “emerging” firms.

Another thing many of these cases have in common is that while the cases often involve a significant share price decline, the complaints often read more like mismanagement claims rather than claims alleging violations of the securities laws. The typical allegations that the defendant companies misled investors and that the companies acted with scienter often are not, shall we say, overwhelmingly
convincing. As Columbia Law School professor John Coffee noted in an article discussing the event-driven securities litigation phenomenon, the plaintiffs' theory of recovery in these cases is often "strained."

To be sure, event-driven lawsuits are not always weak. The largest securities class action settlement in 2017, involving the securities lawsuit filed against BP following the Deepwater Horizon disaster, was an event-driven lawsuit. (The case settled for $175 million.) But though there may well be meritorious event-driven securities suits, many of these kinds of lawsuits are less so.

Even if these kinds of lawsuits often may be successfully defended, they still represent a significant problem of companies and their D&O insurers. Even if the suits lack merit, they still have to be defended. Just getting through a motion to dismiss can be expensive. Moreover, there are still going to be some cases that survive the motion to dismiss, and that then will need to be settled. (That is why the plaintiffs file these kinds of lawsuits; file enough of them, and some of them will survive long enough to reach a payday.) Taken collectively, these kinds of lawsuits represent both a frequency problem and a severity problem. Indeed, the increase in the number of these kinds of lawsuits is one of several factors that are eroding D&O insurers' underwriting results.

The event-driven lawsuits represent a further problem. These cases involved large, unanticipated events. Though these kinds of suits represent a big and growing challenge for D&O insurers, these kinds of risks really are not susceptible to underwriting, at least using the kinds of financial analysis tools on which D&O underwriters rely. D&O underwriters may not be able to protect themselves from these kinds of losses using traditional risk selection and risk segmentation approaches. It may be that the only way D&O insurers can try to protect themselves is price their accounts factoring in the possibility of these unknown risks. However, as discussed below, given the current ample levels of insurance capacity available in the marketplace, the D&O insurers may have relatively little ability to price in an uncertainty cushion.

4. Companies Experiencing Data Breaches Get Hit With Securities Suits
It is not anything new that companies getting hit with data breaches may also have to deal with related D&O litigation. During the time frame 2014 to 2016, there were a number of shareholder derivative lawsuits filed against companies that had experienced data breaches, including, among others, Wyndham Worldwide, Target, and Home Depot. These lawsuits were largely unsuccessful, although the Home Depot case did settle for the defendants’ payment of the plaintiff’s attorneys’ fees while the dismissal was on appeal.

The picture for data breach-related D&O litigation changed this past year. In March 2018, the Yahoo data breach-related securities suit settled for $80 million. The settlement represents the first significant recovery in a data breach-related D&O lawsuit. The Yahoo case may have been somewhat unique, in that the announcement of the data breach caused demonstrable economic harm to Yahoo shareholders after Verizon insisted on renegotiating the price of its pending takeover of Yahoo. Just the same, the settlement represents a milestone because it constitutes the first evidence that plaintiffs’ lawyers might be able to make money on data breach-related D&O lawsuits.

Yahoo’s successor-in-interest Altaba was involved in another legal milestone of sorts in April 2018 when it became the first-ever company to settle a data breach-related SEC enforcement action. Altaba paid $35 million to settle the enforcement action, relating to Yahoo’s delay in disclosing its massive data breach. The settlement and the agency’s earlier release of updated cybersecurity disclosure guidelines underscore the fact that data breach and cybersecurity disclosures remain a high priority for the SEC.

Whether or not the Yahoo settlement encouraged plaintiffs’ lawyers to pursue more data breach-related cases, there were several more data breach-related securities suits filed as the year progressed. The most notable example is the securities lawsuit filed at the beginning of December against Marriott following the company’s announcement of a massive, multi-year data breach of its Starwood reservation system.

In addition, as discussed here, in October 2018, a plaintiff shareholder filed a data breach-related securities suit against online educational service provider Chegg, Inc. and certain of its executives. A few days later, a shareholder of China-based hospitality group, Huazhu, filed a securities class action lawsuit against the company and certain of its directors and officers, as discussed here. In October, a plaintiff
shareholder also filed a data security lawsuit against Alphabet related to data security issues in connection with the company’s Google+ platform, although that lawsuit did not involve a data breach, as discussed here.

The settlement of the Yahoo securities lawsuit and related SEC enforcement action, along with the SEC’s emphasis on cybersecurity disclosure issues, suggests that data-breach and cybersecurity issues generally will continue to be an area of heightened risk for securities litigation. The several data breach-related securities suits filed during the year underscore this point. The recently filed Marriott litigation shows that these cases can be very serious. It seems likely that there will be further data breach and cybersecurity litigation ahead.

5. Privacy Issues Emerge As Another Area of D&O Exposure

The data breach and cybersecurity issues discussed in the preceding section relate to concerns surrounding the way data is secured. A related but different issue involves privacy concerns – that is, the way company’s use the data they have gathered. The Facebook debacle involving revelations that the company transferred user data to Cambridge Analytica highlights the ways the privacy concerns can lead to D&O litigation. The revelations about the transfer of user data to Cambridge Analytica led to a storm of outrage. In March 2018, the revelations also led to a securities class action lawsuit, in which the claimants allege that Facebook’s investors were misled about the company’s privacy policies and use of user data.

The important thing to note is that Facebook’s user data release to Cambridge Analytica did not involve a data breach. The outrage of consumers, politicians, and others, as well investors’ negative reaction, involved concerns that the company was insufficiently protective of its users’ private personal data.

The Cambridge Analytica revelations came to light shortly before the EU’s updated General Data Protection Regulation went into effect in May 2018. These sweeping new regulations impose strict privacy protection requirements throughout the EU, and subject violators to stringent penalties. The regulations have a broad scope, applying to companies outside the EU that collect data on citizens within the EU.
Compounding the privacy-related concerns arising from the GDPR, in late June 2018, California enacted its own privacy legislation. The California bill imposes on businesses significant privacy obligations, creates a number of privacy rights, and provides for enforcement both through private right of action and regulatory enforcement. The Act’s passage arguably represents a significant step toward making privacy issues a prominent part of the liability landscape in the months and years ahead. Another related possibility is the prospect of comprehensive federal privacy legislation, a concept that Apple CEO Tim Cook and others have advanced.

The newly effective regulatory enactments ensure that privacy-related issues are going to be a significant business concern. Among other things, even though GDPR has been in effect only a few short months, it is already clear that regulators intend to use the regulations to impose fines on alleged violators.

A further development during 2018 and also involving Facebook suggests that the new regulatory measures could also involve potential liability and litigation concerns as well. In a quarterly earnings release at the end of July, Facebook disappointed analysts by reporting lower than expected earnings growth for the period. Among other things in explaining the results, company officials cited the unexpectedly high costs and complications associated with the company’s GDPR compliance. The announcement was followed by what is the largest single-day drop in shareholder value ever, as Facebook lost nearly $120 billion in market capitalization on the news. Securities class action lawsuits followed shortly behind.

Facebook is not the only company to be hit with a securities lawsuit after announcing unanticipated costs associated with GDPR compliance. In August 2018, investors filed a lawsuit against Nielsen Holdings plc after the media performance ratings company disclosed in its quarterly earnings release that GDPR-related changes affected the company’s growth rate, pressured the company’s partners and clients, and disrupted the company’s advertising “ecosystem.”

These two recent GDPR-related securities lawsuits highlight the ways in which the new regulations and related emerging concerns about privacy issues can give rise to potential liability. Facebook and Nielsen
are far from the only companies that are going to struggle complying with the new regulatory privacy requirements. Other potential exposures arise from the possibility of follow-on civil lawsuits arising in the wake of privacy-related regulatory actions.

We are in the early days yet as this issue unfolds, but privacy-related concerns could prove to be a significant area of potential D&O liability exposure. The key here is to understand that this is a potential liability exposure that is separate and distinct from liabilities arising from data breaches and cybersecurity generally. This area of exposure involves the way companies use the data they are collecting from their customers and others. Many companies collect these kinds of data, and the ways the companies use this data are going to be a source of increasing scrutiny — and of potential liability exposure, as well.

6. D&O Lawsuits Continue to Follow Revelations of Sexual Misconduct

Late last year, the #MeToo movement passed its first anniversary. As revelations of sexual misconduct have continued to unfold, the accountability process has come to include not only efforts to hold wrongdoers liable, but also efforts to hold boards and corporate management accountable for permitting the behavior or turning a blind eye. There have now been a number of management liability lawsuits filed in the wake of revelations of sexual misconduct, and continuing revelations suggest there may be more to come.

The first of these recent sexual misconduct-related D&O lawsuits was filed late in 2017 against 21st Century Fox. The shareholder derivative lawsuit alleged that the company and its officials tolerated a long-standing culture of sexual harassment, and that the company continued to turn a blind eye to misconduct by high-profile media personalities, ultimately to the detriment of the company as it was forced to pay huge settlements to victims of the harassment. The derivative lawsuit settled for a payment of $90 million — one of the largest derivative lawsuit settlements ever — funded by the company’s D&O insurers.

There have now been a number of other D&O lawsuits filed against company officials in the wake of allegations of sexual harassment or discrimination. For example, during the course of 2018, a plaintiff

shareholder filed a securities class action lawsuit against CBS following revelations of alleged sexual misconduct against the company's CEO. Other companies hit with D&O lawsuits during 2018 and arising out of sexual misconduct allegations include Papa John's International (here); National Beverage Corp. (here); and Wynn Resorts (here). There was even a securities lawsuit filed in December against Teladoc Health based on revelations of an apparently consensual relationship between a male executive and a younger female subordinate (discussed here).

As time has gone by and as further lawsuits have been filed, the nature of the underlying allegations of wrongdoing has started to shift. For example, as discussed here, in August 2018, a Nike shareholder filed a derivative lawsuit against the company's board, alleging that the board had permitted a "boys' club" atmosphere in which men advanced but women were held back from advancement and pay increases. The allegations in the Nike lawsuit differ from the sexual misconduct allegations raised in earlier lawsuits.

In the prior cases, the alleged underlying misconduct involved alleged instances of unwanted advances, inappropriate touching, or the use of corporate power to try to extract sexual favors. The allegations at Nike are more in the nature of hostile work environment. In both cases, the women who were the victims were demeaned and disadvantaged; but the allegations at Nike do not turn so much as the other cases on specific allegations of unwanted sexual advances or inappropriate touching.

The fact that the Nike lawsuit arose in the wake of hostile workplace environment allegations suggests that the possibility of these kinds of lawsuits may extend beyond just companies at which executives engaged in unwanted sexual advances and sexual contact. The allegations that the Nike board failed in its oversight duties by permitting pay inequity and inequities in advancement and promotion suggests the possibility that the potential liability exposure could sweep much more broadly.

In any event, it does seem that we are going to continue to see management liability lawsuits arising out of sexual misconduct and disparate treatment. As two commentators put it in a recent guest post on this site, "With the increased focus on sexual harassment in the news, the apparent increased willingness of employees to report such behavior, and a climate where state and local governments are stepping up to
support the movement, employers (including directors and officers) and insurers should recognize that an increase in sexual harassment claims and lawsuits may be inevitable."

7. California Wildfires-Related Litigation Suggest Possible Direction of Future Climate Change-Related D&O Claims

For many years, the possibility of climate change-related D&O claims has hovered on the periphery of the discussion of D&O liability issues. By and large, however, concerns about the issue have not translated into claims. The one notable exception is the securities class action lawsuit investors filed against ExxonMobil and certain of its directors and officers in November 2016. Investors alleged that the company had a far different internal view of the potential impacts on the company’s future ability to realize the full value of its hydrocarbon assets than the one the company communicated publicly. In August 2018, the court denied the defendants’ motion to dismiss the lawsuit, suggesting at a minimum that the ExxonMobil lawsuit will go forward.

Though the ExxonMobil lawsuit has survived the initial pleading hurdles, there have not been other climate change-related cases filed in the U.S. There have been some examples from outside the U.S. where advocacy groups have filed litigation aiming to try to encourage reporting companies to beef up their climate change disclosure. For example, On August 2, 2018, the non-profit legal group Client Earth filed complaints with the U.K. Financial Conduct Authority (FCA) against three different U.K. insurers. The legal group contends that the insurers’ annual reports failed to meet the requirements of the Disclosure Guidance and Transparency Rules due to the absence in the reports of any climate change-related disclosures. A similar action seeking increased climate change-related disclosure was filed in Australia against one of the leading banks. But while these disclosure cases make for interesting discussion points, the fact is that there has not yet been a volume of climate change-related disclosure litigation.

However, a different development during 2018 suggests that climate change-related D&O litigation could develop from a completely different direction. Late last year, just after the devastating California wildfires, two of its leading California electrical utilities were sued in management liability lawsuits. In each case, the utilities’ electrical facilities or operations were alleged to have been involved in starting
the wildfires, leaving the companies vulnerable to litigation based upon alleged wrongful deaths or property damage.

For example, in the securities class action lawsuit filed in November 2018 against the utility company Edison International, the plaintiff shareholder alleges that investors were misled about the company’s fire safety readiness and vulnerability if there were to be a wildfire.

In a separate November 2018 development, a shareholder of PG&E, another California electrical utility, filed a shareholder derivative lawsuit referring to the company’s involvement in a series of wildfires, and alleging that the company had made misrepresentations about its fire safety management and fire readiness. PG&E had actually been the subject of another securities class action lawsuit filed earlier in 2018 relating to the company’s involvement in the 2017 California wildfires.

These lawsuits clearly represent examples of the kinds of event-driven litigation I discussed above. But in addition these cases arguably represent something else; these cases could represent examples of the kind of management liability litigation that could emerge as a result of changes arising from climate change.

In the recent report issued by the federal government’s interagency task force on climate change, among the potential risks the report noted might emerge as climate change progresses is an increase in the frequency and severity of wildfires. The recent lawsuits filed against the California electrical utilities show the kinds of claims that might emerge against company management if indeed wildfires were to become more frequent and more severe. And what is true of wildfires arguably is true of the many other risks that the government report said might arise from climate change.

Companies whose operations will be affected by the changing physical conditions arising from climate change could find themselves the target of claims from investors and other constituencies for failure to anticipate and guard against climate change-related conditions — not just with respect to wildfires
alone, but also (for example) relating to coastal flooding, drought, supply chain disruption, political unrest, and the many other kinds of effects and consequences that climate change may cause.

These kinds of lawsuits might not only involve the kinds of underlying problems alleged in the cases involving the California utilities, where operations were affected by climate change-related conditions, but could also relate, for example, to supply chain disruptions; disruptions in supply of key materials or parts; failures to account for changing costs or contingent liabilities; as well as a host of other claims and assertions.

To be sure, climate change has been discussed as a potential source of management liability claims for many years, yet by and large the claims have not really materialized. It may be that the claims may not ever materialize, at least not in volume. But the recent lawsuits filed against the California electrical utilities suggest what the climate change-related D&O claims, if they do ever emerge, might look like.

8. SEC Enforcement Action Rebounds

In the 2017 fiscal year ending September 30, 2017, during the first full reporting year under the current Presidential administration, the SEC's enforcement activity slumped significantly compared to prior years. Many commentators at the time speculated that the statistics could suggest that the current administration is taking more restrained enforcement approach. However, in November 2018, when the SEC released its enforcement figures for the 2018 fiscal year, the agency’s statistics for the year undercut the prior suggestion that the agency was taking a softer approach. Both the volume of SEC enforcement activity and the level of financial recoveries increased in the 2018 fiscal year.

Though the SEC Enforcement Division’s co-directors cautioned against putting too much weight on quantitative measurements, the fact is that the enforcement numbers are very closely followed. As the Wall Street Journal noted in its November 3, 2018 article about the agency’s enforcement report, the SEC’s annual enforcement statistics “are a closely watched indicator of its oversight of public companies, financial institutions, and stockbrokers. The figures tend to be used, particularly by Congress, as a barometer of how aggressively the SEC is policing misconduct.”
The agency’s latest enforcement activity report shows that in the 2018 fiscal year, the agency brought 821 enforcement actions, compared to 754 in FY 2017, representing an increase of almost nine percent. Of the 821 enforcement actions in FY 2018, 490 were stand-alone actions, representing an increase of about 10% over the 446 stand-alone actions brought in the prior fiscal year.

A separate analysis of the SEC’s enforcement figures by the NYU Pollack Center for Law & Business and Cornerstone Research also found that SEC enforcement actions specifically against public companies and subsidiaries “jumped substantially” in the second half of FY 2018, reversing a decline in filings that began in the second half of 2017 and continued through the first half of 2018.

The NYU and Cornerstone Research report shows that of the 490 stand-alone enforcement actions the SEC initiated during the 2018 fiscal year, 71 involved new actions against public companies and subsidiaries, representing an increase of nine percent from FY2017. However, the FY2018 increase was largely a reflection of the activity during the second half of FY 2018, during which the agency filed 55 new actions against public companies and subsidiaries. By way of comparison, the two half-year periods preceding the 2H18 each had fewer than 20 public company enforcement actions. The 71 public company enforcement actions during FY2018 were well above the FY 2010- FY 2017 annual average of 58.

The NYU and Cornerstone Research report itself contains no analysis or speculation on why the numbers of public company enforcement actions jumped so significantly in the second half of 2018. The increase in public company enforcement actions mirrors the overall increase in SEC enforcement activity during the year’s second half.

The increased level of activity in FY 2018 presents quite a contrast with the reduced levels of enforcement activity during the 2017 fiscal year. The increase suggests that whatever the overall administrative view may be toward regulatory activity, the approach is not so comprehensive that it precludes an active enforcement approach from the SEC.
The interesting question is whether the heightened level of activity at the end of the 2018 fiscal year will continue during the current fiscal year. Without knowing for sure what caused the surge in the second half of 2018, it is hard to speculate about whether the increase level of activity will continue into the current year.

However, one detail in the SEC's annual report may provide a glimpse of what we should expect. According to the SEC's report, as of the end of the 2018 FY, the agency had over 225 cyber-related investigations pending. This detail might suggest that we will be seeing a significant amount of cyber-related enforcement activity during FY 2019, which could drive the overall enforcement numbers for the fiscal year. In any event, the agency's filing activity during the second half of 2018 suggests that it would be a mistake to assume that the agency will not be active in pursuing enforcement actions.

9. Social Media Communications Emerge as a Source of Potential D&O Liability

The possibility of a securities class action lawsuit based on alleged misrepresentations made on social media has been around as long as there have been social media. The possibility has been apparent at least since 2013, when Netflix CEO Reed Hastings used his Facebook account to announce that Netflix subscribers had surpassed 1 billion users. That sparked an SEC investigation looking into whether Hastings' Facebook post violated Reg FD. The SEC ultimately concluded that companies can use social media to announce key information in compliance with Reg FD as long as investors have been told to look there.

The recognition that companies could use social media for company announcements raised the possibility that investors would later claim that a company statement on Twitter, Facebook, or other social media outlet was misleading and should be the basis of liability under the federal securities laws. That possibility became a reality this past August, when a Twitter storm by Tesla's Chairman and CEO Elon Musk led first to a stock market rally and bust, and then to a group of securities class action lawsuits.
On Tuesday August 7, 2018, Musk set the securities markets and the business pages alight with an extraordinary series of Tweets on his Twitter feed, in which Musk stated, among other things, that he is “considering taking Tesla private” at a price that represented a substantial premium over the current share price; that “funding secured”; “shareholders could either sell to [SIC] sell at 420 or hold shares & go private”; and “Investor support confirmed.”

The company’s share price leapt upwards, to an inter-day high 13% above the prior day’s closing price. The trading volume in Tesla’s share rose to 30 million shares (compared to an average daily trading volume of 8 million), representing over $11 billion of purchases in the open market.

Almost immediately questions arose about the source of the funding Musk referred to, as well as the extent to which the company’s board had considered and approved the supposed take-private transaction. The company’s share price declined and within days investors had filed a series of securities class action lawsuits. Media sources also reported that the SEC was investigating Musk’s tweets and the supposed take-private deal.

The securities class action lawsuits were followed in September 2018 by an SEC securities fraud enforcement action against Tesla and Musk, in which the agency alleged that Musk’s statements in the Tweets were “false and/or misleading” because “he did not have an adequate basis in fact for making these assertions.” Just a few weeks later, the SEC announced that it has reached a settlement with Musk and the company, in which Musk agreed to change his role at the company, and in which Musk and the Company each agreed to pay $20 million, with the $40 million total to be paid to investors under a court-supervised process.

Tesla is far from the only company that uses social media to communicate with the investment community. Most of these corporate communications are entirely benign. However, using social media does involve certain risks. The media’s relative informality compared to traditional corporate communications methods creates the possibility of statements that are insufficiently filtered or reviewed. Musk’s take-private tweets certainly seem to illustrate these risks. Tesla may be the first company to get hit with a securities class action lawsuit based on allegedly misrepresentations made using social media, but it is unlikely to be the last.
The possibility that a company's (or one of its executive's) use of social media might give rise to a securities lawsuit is yet another headache for D&O underwriters. Underwriters already are compelled to review all of a public company’s SEC filings and financial statements. As the foregoing sections underscore, underwriters must now also consider, among other things, an applicant company's data security, privacy protections, vulnerability to climate change, and human resource practices. If that were not enough, now underwriters must also consider a company's social media approach and even review the social media entries, to consider whether opportunistic plaintiffs' lawyers might be able to try to allege that a post violated the securities laws.

10. The Current Landscape Creates a Difficult Environment for D&O Insurers

As the above discussion shows, it is a difficult environment for D&O insurers. There are three specific challenges the insurers now face.

First, with the heightened volume of securities class action lawsuits over the last two years, the carriers are now carrying a massive load of unresolved cases. These cases all have to be monitored and administered. But of even more importance, the carriers have to estimate, establish and maintain appropriate reserves for all of these cases, with obvious negative consequences for the insurers' underwriting results.

Second, many of the current claims trends present particular underwriting challenges for the insurers. In the past, D&O underwriting was focused almost exclusively on reviewing and assessing an applicant's financial statements. But many of the emerging claims trends do not relate to companies' financial condition or even financial performance. An applicant company's potential exposure to claims arising from data breaches, privacy concerns, sexual misconduct allegations, climate change, or social media practices in most instances cannot be discerned from reviewing the company's financial statements – indeed, those kinds of exposures may not be susceptible to being underwritten at all. At a minimum, the traditional approach to D&O underwriting may no longer be sufficient.
Third, the way D&O insurers would want to try to protect themselves from these emerging risks is by charging a premium sufficient to compensate the insurers for underwriting uncertainty. That is where the insurers face their biggest problem. The fact is that there is still abundant capacity in the D&O insurance marketplace. The market remains competitive. Insurers’ ability to raise rates (at least without the willingness to risk losing business) is constrained. An insurer’s efforts to try to raise rates may not be supported in the marketplace.

Insurers these days are quite forward in complaining about the pressure they are under. Years of pricing decreases combined with increasing claims volumes, along with deteriorating results in prior underwriting years, present a pretty unattractive equation for the insurers. Many insurers are now saying that they intend to push for rate increases in 2019, particularly for larger market cap public companies and for private companies.

And in fairness to the insurers, there is some evidence to suggest that they did achieve slight rate increases in certain areas in 2018, particularly for smaller market cap public companies. There is also some evidence that with respect to certain difficult classes of business – for example, with respect to California-domiciled companies, life sciences companies, IPO companies – the insurers are achieving greater pricing power, at least with respect to the primary layers of some public company accounts.

Regardless of whether or not the insurers succeed in achieving across the board price increases in 2019, they can be expected to take a more defensive approach in certain situations – for example, with respect to IPO companies and with respect to life sciences companies. As always, companies in poor financial condition will continue to be viewed as distressed risks.

In any event, everyone in the D&O insurance industry – insurers, agents, and buyers – will continue to watch the emerging trends as we head into 2019. Will the elevated levels of securities class action lawsuit filings continue? Will we continue to see data breach D&O lawsuits and lawsuits following on sexual misconduct allegations filed? Will privacy issues emerge as an important source of D&O claims? Will climate change issues emerge as a significant area of management liability exposure? There will be much to watch in the months ahead.
**Alternative Top Ten Lists:** Over the holidays and in anticipation of this Top Ten post, I published a series of alternative top ten posts, dealing not, as is usually the case with this blog, with insurance or legal topics, but dealing instead with travel topics. Even though the holidays are over, I invite everyone to have a look at the alternative Top Ten Posts, to which I have linked below:

- Top Ten Places (That You Might Not Think of) to Visit (including Top Ten Urban Hikes), here.
- Top Ten Top Travel Destinations (including Top Urban Parks), here.
- Top Ten: London (including Top Pictures of Animals), here.
- Top Ten: Paris (including Top Pictures of Food), here.
- Even More Top Ten Travel Lists! (including Top Ten Museums, Top Ten Places to Have a Beer, and Top River Pictures), here.

I had fun putting these lists together (especially the pictures), and I hope everyone will have a look.
Securities Suit Filings Continued at Heightened Pace in 2018

By Kevin LaCroix on January 6, 2019
Posted in Securities Litigation

The heightened pace of securities class action lawsuit filings continued in 2018, as filing levels remained well above historical patterns, even though the total number of suits dipped very slightly compared to 2017. The total number of filings during 2018 was significantly inflated by the number of federal court merger objection lawsuit filings during the year. However, even disregarding the M&A-related lawsuits, the number of traditional lawsuit filings during 2018 was well above long-term averages. Even more significantly, the litigation rate (that is, the number of suits relative to the number of listed companies) arguably was at all-time record high levels in 2018 compared to prior years, as discussed further below.

The Number of Securities Class Action Lawsuit Filings

There were 403 federal court securities class action lawsuits filed in 2018, compared to 412 in 2017, representing a year-over-year decline of about 2%. While the number of federal court class action securities suits declined slightly in 2018 compared to the year prior, the 403 suit filing total in 2018 is about 209% above the 1996-2016 annual average number of filings of 193. The 403 filings total in 2018 is second only to the 412 filings total in 2017 as the highest annual number of filings since the IPO laddering lawsuit-inflated total of 498 in 2001.

Merger Objection Lawsuit Filings
The 2018 total number of filings was significantly elevated by the number of federal court merger objection lawsuit filings during the year. Of the 403 total federal court securities class action lawsuit filings during the year, 185 were merger objection lawsuit filings, representing about 46% of the total. These federal court merger lawsuits in the past likely would have been filed in state court. However, in a series of rulings culminating in the Trulia decision, the Delaware courts have evinced their hostility to these kinds of cases, as a result of which the plaintiffs’ lawyers increasingly are filing M&A lawsuits in federal court, alleging violations of federal securities laws.

*Traditional Securities Lawsuit Filings*

However, even without regard to the significant numbers of federal court merger objection lawsuit filings during the year, the 2018 filings were at elevated levels compared to long-term averages.

Of the 403 total number of federal court securities class action lawsuit filings during the year, 218 were “traditional” securities class action lawsuits. The total of 218 traditional securities lawsuit filings during 2018 is nearly 13% above the 1996-2016 annual average total number of all filings of 193. The 218 number of traditional filings in 2018 is in fact the highest annual number of traditional filings at least since 2008. In other words, even without the significant numbers of federal court merger objection lawsuit filings, the 2018 securities class action lawsuit filings were at or near historically high levels.

*State Court Securities Class Action Litigation*

There is a significant additional factor that must be taken into account in assessing the level of securities class action lawsuit filing activity in 2018, and that is the volume of Section 11 class action lawsuits being filed in state court rather than federal court.

As readers will recall, in March 2018, the U.S. Supreme Court held in the Cyan case that state courts retain concurrent jurisdiction for liability actions under the Securities Act of 1933. In the wake of the Cyan decision, plaintiffs have filed a significant number of IPO-related lawsuits in state court. Many of these state court lawsuits have parallel federal court lawsuits; however, in a number of instances, the
state court suits have no parallel federal court action. The state court filings are much more difficult to track than the federal court lawsuits.

The bottom line is that, in light of the heightened level of state court securities class action filing activity, the federal court filing data discussed above is no longer a sufficient measure by which to gauge overall securities class action lawsuit filing levels.

Without having the exact state court filing figures to analyze, it may be hard to say, but it seems likely that if the state court filings are taken into account, the overall number of securities class action lawsuit filings in 2018, considering both federal and state filings, was greater than the equivalent figures in 2017; if that were true, that would make the 2018 filing activity the highest since at least 2001.

**The Litigation Rate**

It is of course significant to compare the number of lawsuits filed in 2018 to the number of lawsuit filings in prior years. However, the more meaningful comparison is to contrast the rate of litigation in 2018 – that is, the number of lawsuits in relation to the number of U.S. listed companies – to the litigation rate in prior years.

The litigation rate has been escalating significantly in recent years, as the number of securities suit filings has continued to increase while the number of publicly traded companies has declined (due to mergers, bankruptcies, going private transactions, etc.). Thus, for example the litigation rate in 2017 was at an all-time high of 8.4% (compared to a 1996-2016 annual average litigation rate of 2.9%).

As high as the litigation rate was in 2017, the litigation rate in 2018 was even higher. Of the defendant companies hit with securities lawsuits in 2018, 385 were listed on U.S. exchanges. Using the 2017 yearend total number of publicly traded companies for calculation purposes (4,411), the 385 securities lawsuits filed against listed companies in 2018 translate to a 2018 litigation rate of 8.7%, which is not only higher than the rate in 2017 but is in fact the highest rate since at least 1996. In other words, the
chances of a U.S.-listed company getting hit with a securities suit arguably were higher in 2018 than it has ever been.

The litigation rate comparison stands even if the effect of the merger objection lawsuit filings is disregarded. Of the 218 traditional securities lawsuits filed in 2018, 202 involved companies listed on a U.S. exchange, which implies a litigation rate of 4.6%, compared to an equivalent litigation rate of 4.2% for 2017. That is, even just with respect to traditional securities litigation, the chance of a U.S.-listed company getting hit with a securities suit was at its highest-ever level in 2018.

To put these litigation rates into perspective, the chances of a U.S.-listed company getting hit with a securities suit in 2018 approached one out of ten. The chances of a U.S.-listed company getting hit with a traditional securities suit during 2018 approached one out of twenty. Both of these figures are at all-time high levels.

Factors Contributing to Securities Class Action Filings Activity

A number of significant factors contributed to the elevated 2018 filing totals. In addition to the merger objection lawsuits, another factor driving filing activity in 2018 was the continued emergence of event-driven securities litigation. These event-driven suits are not based on allegations of accounting fraud or financial misrepresentation, but rather are based on the occurrence of an adverse event in the defendant company’s operations. These kind of lawsuit filings included in 2018, for example, the securities suit filed against California utility companies Edison International and PG&E in the wake of the California wildfires; the lawsuit filed against Boeing after the Lion Air Flight 610 plane crash; or the suit filed against Marriott after the company disclosed a significant breach of its Starwood Group customer database.

Another factor contributing to the elevated 2018 activity levels is the number of securities class action lawsuits filed against cryptocurrency companies and other organizations conducting initial coin offerings (ICOs). There were at least nine securities class action lawsuits filed in 2018 involving ICOs or cryptocurrency companies.
Industries Targeted

The 2018 securities class actions targeted companies in a wide variety of industries. The 2018 federal court securities lawsuits were filed against companies in 161 different Standard Industrial Classification (SIC) Code categories.

As has been the case in prior years, the SIC Code category with the highest number of securities class action lawsuit filings in 2018 was SIC Code category 2834 (Pharmaceutical Preparations) which had 41 lawsuit filings during the year, representing more than 10% of the federal court securities lawsuits filed during the year.

Life sciences companies generally were targeted at elevated levels in 2018. Thus there were a total of 51 lawsuits filed against companies in SIC Industry Group 283 (Drugs), representing nearly 13% of all 2018 securities lawsuit filings, and there were an additional 12 lawsuits against companies in SIC Industry Group 384 (Surgical, Medical, and Dental Instruments). The total of 63 lawsuits filed in 2018 against companies in these two groups together represented over 15% of all federal court securities suit filings during the year.

Another industrial group that experienced significant levels of securities litigation activity in 2018 was the high tech sector. There were a total of 38 lawsuits filed against companies in Industry Group 737 (Computer Programming and Data Processing) and an additional 13 lawsuits against companies in Industry Group 367 (Electrical Components and Accessories), including 11 lawsuits filed against companies in SIC Code category 3674 (Semiconductors). The 50 lawsuits filed against companies in these two industrial groups represented about 12.4% of the federal court securities suit filings in 2018.

Together the securities suit filings against life sciences and high tech companies represented a total of about 28% of all federal court securities suits filed in 2018.
**Federal Court Securities Lawsuit Distribution**

The 2018 federal court securities class action lawsuit filings were distributed across a wide number of federal court districts. During 2018, federal court securities class action lawsuits were filed in 50 different federal district courts.

The U.S. district court with the highest number of securities class action lawsuits in 2018 was the Southern District of New York. There were a total of 67 securities class action lawsuits filed in the S.D.N.Y. in 2018, representing 16.6% of all 2018 securities class action lawsuit filings. There were an additional 21 lawsuits filed collectively in the Eastern District of New York, the Western District of New York, and the Northern District of New York (19 in the E.D.N.Y. alone), bringing the total of securities suits filed in the New York federal court districts to 88, representing about 22% of all federal court securities suits filed in 2018.

Outside of New York, the federal court district with the highest number of securities suit filings in 2018 was the District of Delaware, where there were 58 securities suit filings in 2018, representing about 14.3% of all 2018 federal court filings. However, of the 58 suits filed in the District of Delaware, 55 were merger objection lawsuits, clearly reflecting the diversion of merger suits from state court to federal court.

Outside New York and Delaware, the federal district with the highest number of securities lawsuit filings was the Northern District of California, which had 54 securities suit filings in 2018, representing 13.4% of all 2018 federal court securities suit filings. There were an additional 29 securities suit filed collectively in the Central District of California, the Eastern District of California, and the Southern District of California (including 24 in the C.D.Cal. alone) bringing the total number of securities suit filings in the California federal courts to 83, representing 20.6% of all 2018 securities suit filings.

Taken together, the New York, Delaware, and California federal court securities suit filings totaled 239, representing 59.3% of all 2018 federal court securities suit filings.
Other federal district courts that had significant number of securities suit filings in 2018 were the District of New Jersey (26), the Northern District of Illinois (14), the District of Massachusetts (12), and the Northern District of Texas (11).

Non-U.S. Companies

Of the 403 federal court securities lawsuits filed in 2018, 51 (or about 12.65%) involved non-U.S. companies. If the suits involving non-listed companies (such as for example the lawsuits involving ICO companies) are taken out of the equation, the lawsuits against non-U.S. companies represented about 13.24% of the federal court securities suits in 2018. Of the 51 lawsuits against non-U.S. companies, ten were merger-related, and 41 were “traditional” securities lawsuits.

The federal court securities suits against non-U.S. companies in 2018 involved companies from 19 different countries. The countries with the highest number of U.S. federal court securities lawsuits in 2018 were Canada (with 6), Ireland (6), China (5) and the U.K. (4). Of the 51 federal court securities suits filed against non-U.S. companies in 2018, six were bribery or corruption follow-on lawsuits.

IPO Companies

Of the 403 federal court securities class action lawsuits filed in 2018, 15 involved IPO companies (that is, the allegations related to the company’s initial public offering transaction). This figure does not of course take into account IPO companies that may have been named as defendants in state court securities class action lawsuits. As noted above, while many of the state court securities suits involve parallel federal court actions, some do not, meaning that the federal court tally of IPO-related lawsuits may (and likely does) undercount the number of IPO companies sued in securities class action lawsuits in 2018.

Of the IPO companies sued in federal court securities class action lawsuits in 2018, one completed its IPO in 2016, ten completed their IPOs in 2017, and four completed their IPO in 2018.
Discussion

The most important takeaway from the 2018 filing figures is that, contrary to an unfounded belief that seems to be widely circulating in the D&O marketplace, the securities class action lawsuit filing activity has not dropped significantly compared to 2017. The level of federal court securities class action filing activity remains at or near historically high levels. The scuttlebutt circulating in the marketplace that new lawsuit activity is down is completely unfounded. The numbers don’t lie.

Indeed, assessing the 2018 securities suit filing activity arguably requires taking into account some additional considerations not present (or not as significantly present) in prior years; that is, the heightened level of state court securities class action lawsuit activity as a result of the March 2018 Cyan decision must also be taken into account. As noted above, when the additional state court activity in 2018 is taken into account, the number of securities class action lawsuits in 2018 may well be higher than in 2017.

Separate and apart from the raw number of lawsuits filed, the rate of litigation arguably was higher in 2018 compared to prior years, including compared to 2017. As noted above, the likelihood of a U.S.-listed company getting hit with a securities lawsuit arguably was higher in 2018 than in any prior year.

The 2018 filing data should also dispel another myth that has been circulating in the D&O marketplace, which is that the problem of federal court merger objection lawsuits is going away. I have no idea where this idea is coming from, but the data don’t lie – federal court merger objection lawsuits continued to be filed at significant levels, apparently unabated. To be sure, the way these suits are being resolved now may have changed (with plaintiffs’ attorneys now agreeing to dismiss the suits in exchange for the defendants’ agreement to pay a mootness fee), but that is a different issue. The fact is that the plaintiffs’ lawyers are continuing to file federal court merger objection lawsuits.

Another important point from the above analysis is that while the total number of federal court securities lawsuit filings is significantly inflated by the merger objection lawsuit filings, traditional securities class action lawsuits were filed at significantly elevated levels during 2018. Indeed, as the
analysis above shows, both the number of traditional securities lawsuits and the rate of filing of traditional lawsuits arguably were at or near all-time high levels in 2018.

The undeniable significance of the state court securities class action lawsuit filings in the wake of the Cyan decision points to both a record-keeping problem and an analytic problem. Because of the difficulty of obtaining reliable and accurate state court litigation data, the process of trying the measure securities class action lawsuit activity is now significantly more complicated. It could be argued that without the state court data taken into account, the securities suit filing analysis is at best incomplete. It may well be that other services tracking securities suit filings activity will be better able to track the state court activity, but at a minimum the process of trying to keep an accurate and complete picture of overall securities lawsuit filing activity is now a lot more complicated.

The significantly elevated level of securities lawsuit filings activity during the last two calendar years is a problem both for publicly traded companies and for their insurers. The increased likelihood for a company to get hit with a securities suit is a significant threat for public companies. For their insurers, the heightened threat of securities litigation represents a significant pricing challenge, particularly at a time of ample insurance capacity and the resulting difficulty in seeking rate increases.

The elevated level of securities lawsuit activity over the last two calendar years represents another kind of problem for the D&O insurers. Even though the dismissal rate has increased recently, the fact is that the D&O insurers now have a massive volume of securities suits in their claims pipelines. This mass of claims not only needs to be processed and administered, but reserves for these claims must be estimated, established, and maintained. The need for appropriate reserving on this mass of claims has significant implications for the insurers’ underwriting results, particularly (but not just) for the primary insurers.

The mass of litigation over the last couple of years has not gone unnoticed. Indeed it has already set off alarm bells in certain quarters. The U.S. Chamber Institute of Legal Reform has already sounded the call for another round of securities class action litigation reform. Clearly, there is some important work for Congress to do to help with this situation. One thing Congress could do for sure is to clean up the mess it made with SLUSA, and clarify that class action lawsuits under the federal securities laws can only be
filed in federal court. Another possibility is that Congress could clarify that there is no private right of action under Section 14 of the Securities Exchange Act of 1934 – that would eliminate the curse of federal court merger objection litigation.

In any event, looking ahead, we should all continue to expect to see elevated levels of securities class action activity. Much of the activity in 2017 and 2018 was driven by the hyperactivity of a very small number of so-called “emerging” plaintiffs’ firms, and there is every sign that these law firms will continue to pursue this active approach during 2019. At the same time, we will continue to hear calls for securities litigation reform.

A Preview of Coming Attractions: I will be publishing my annual Top Ten D&O Stories report on the morning of Tuesday, January 8, 2019.

More About Securities Class Action Litigation Reform: Those interested in the topic of Securities Class Action Litigation Reform will want to know about the webinar that the Professional Liability Underwriting Society (PLUS) will be hosting on Wednesday January 16, 2018 at 1 pm EST. The webinar will be moderated by Sara Brody of the Sidley Austin law firm. The other speakers will include Andrew Pincus of the Meyer Brown law firm, who authored the U.S. Chamber Institute of Legal Reform study about securities litigation reform to which I linked above, and Robert Wolfe of Chubb. Information about the webinar, including registration details, can be found here.
Guest Post: Section 11 Claims May Remain in State Court; How Will Companies and D&O Carriers Respond?

By Kevin LaCroix on January 15, 2019
Posted In Securities Laws

As I noted at the time (here), on December 19, 2018, Delaware Vice Chancellor Later held that under Delaware law, a corporate charter provision specifying that liability actions under Section 11 of the Securities Act of 1934 must be brought in federal court are invalid and ineffective. A copy of Laster's opinion in Sciabacucchi v. Salzburg (referred to below as the Blue Apron decision) can be found here. In the following guest post, Paul Ferrillo, Robert Horowitz, and Steven Margolin of the Greenberg Traurig law firm take a look at the Blue Apron decision and examine whether or not Congress will act to eliminate concurrent state court jurisdiction for state court claims. The authors also examine the steps companies should take now in light of the possibility of facing litigation in both state and federal court. I would like to thank the authors for their willingness to allow me to publish their article as a guest post. I welcome guest post submissions from responsible authors on topics of interest to this blog’s readers. Please contact me directly if you would like to submit an article. Here is the authors’ article.

Given that historical federal securities outcomes in state courts outside of Delaware often created outcomes that were not only more uncertain but more costly as well, there was some hope that Vice...
Chancellor Travis Laster ("VC Laster"), in the Blue Apron decision, might find that bylaws designating a federal forum for Section 11 lawsuits (brought under Section 11 of the Securities Act of 1933 (the "‘33 Act")) would stand the test of Delaware’s “internal affairs” doctrine, which relates to the Delaware Court’s traditional jurisdiction over internal matters relating to the relationships among or between a corporation and its officers, directors, and shareholders. That was not the case, however, as VC Laster ruled that a claim under the ‘33 Act is “external” to the corporation because “[f]ederal law creates the claim, defines the elements of the claim, and specifies who can be a plaintiff or a defendant.” VC Laster thus denied the Company’s attempt to create exclusive federal jurisdiction via its bylaws.

This decision, though understandable as a matter of Delaware law, leaves two questions hanging:

(1) Will Congress act to create exclusive federal jurisdiction for class actions alleging only Section 11 claims?

(2) What are companies to do now, with the prospect of litigating IPO-related claims in both federal and state courts, at the same time and perhaps in different places?

We explore both questions more below and, in doing so, briefly summarize the somewhat complex set of circumstances that have led us here.

**Background**

At least in part, the Blue Apron decision flows from two guiding principles. First, by enacting Section 11 of the ‘33 Act, Congress created concurrent jurisdiction in both federal and state courts. This contrasts with the provisions of the Securities Exchange Act of 1934 (the “‘34 Act”), which gave the federal courts exclusive jurisdiction over open-market, “securities fraud” claims brought by shareholders under Section 10b of the 34 Act. Many times this jurisdictional difference worked itself out because plaintiffs often brought both Section 11 and Section 10(b)-5 claims in the same federal court complaint. But not always.
Second, Congress had a chance in 1998 to fix federal court jurisdiction for all federal securities claims when it passed the Securities Litigation Uniform Standards Act (SLUSA), which provided that:

No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging—

(1) an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security; or

(2) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.

As noted by VC Laster in Blue Apron, “The Federal Jurisdiction Statute (of SLUSA) forces plaintiffs to sue in federal court if they wish to pursue class-wide relief involving publicly traded securities on a fraud-based theory, regardless of whether the cause of action invokes federal or state law. To make sure that plaintiffs cannot bypass the Federal Jurisdiction Statute by ignoring it and filing in state court, SLUSA permits the removal of certain class actions to federal court.” Blue Apron, at 10-11.

But what exactly did SLUSA do? Did it mandate that all federal securities claims brought as class-actions, whether under Section 11 of the ’33 Act or Section 10(b) of the 34 Act, be brought in federal court? Or did it leave the ’33 Act’s state court jurisdictional provisions alone, intending SLUSA to apply to class actions alleging only state statutory or common law claims? This question was left unanswered for a very long time, until the United States Supreme Court (the “Supreme Court”) resolved it in Cyan, Inc. v. Beaver County Employees Retirement Fund (“Cyan”), ruling unanimously that, class actions under the ’33 Act (1) may be brought in state court pursuant to SLUSA, and (2) are not removable to federal court.

The Blue Apron Decision

The Blue Apron case was filed as a class action in Delaware state court before the Supreme Court’s Cyan decision, and was brought by a plaintiff who purchased shares in three companies that had (in their
bylaws or charters) designated federal courts as the exclusive forum for '33 Act claims: Blue Apron, Stitch and Roku. The plaintiff alleged Section 11 claims under the '33 Act arising from the IPO of each company, whose registration statements each included a forum selection clause which generally stated:

Unless the Company consents in writing to the selection of an alternative forum, the federal district courts of the United States of America shall be the exclusive forum for the resolution of any complaint asserting a cause of action arising under the Securities Act of 1933. Any person or entity purchasing or otherwise acquiring any interest in any security of the Corporation shall be deemed to have notice of and consented to [this provision]

Thus, it was clear that the companies intended to require any plaintiff suing under Section 11 of the '33 Act to litigate in federal court.

VC Laster's decision in Blue Apron held that limitation was invalid as a matter of Delaware law, but the decision was not written on a blank slate; then-Chancellor Stine's decision in Boilermakers Local 154 Ret. Fund v. Chevron Corp., 73 A.3d 934 (Del. Ch. 2013) ("Chevron") had helped pave the road several years earlier. The Chancellor (who now sits as Chief Justice of the Delaware Supreme Court) found that certain forum selection provisions found in Chevron's bylaw addressed only internal affairs claims, holding that:

a matter of easy linguistics, the forum selection bylaws address the “rights” of the stockholders, because they regulate where stockholders can exercise their right to bring certain internal affairs claims against the corporation and its directors and officers. They also plainly relate to the conduct of the corporation by channeling internal affairs cases into the courts of the state of incorporation, providing for the opportunity to have internal affairs cases resolved authoritatively by our Supreme Court if any party wishes to take an appeal. That is, because the forum selection bylaws address internal affairs claims, the subject matter of the actions the bylaws govern relates quintessentially to “the corporation’s business, the conduct of its affairs, and the rights of its stockholders [qua stockholders].
Chief Justice Strine thus distinguished those claims that were *internal* to the Corporation (like derivative and breach of fiduciary duty lawsuits), where jurisdiction of the Delaware Chancery Court could be mandated, from those types of claims that were *external* to the corporation (like securities fraud claims brought by shareholders).

Two years after *Chevron*, the current version of Section 115 of the Delaware General Corporation Law (“DGCL”) was adopted and legislatively confirmed the ability of Delaware corporations to include forum-selection provisions in their charters and bylaws. It states:

> The certificate of incorporation or the bylaws may require, consistent with applicable jurisdictional requirements, that any or all internal corporate claims shall be brought solely and exclusively in any or all of the courts in this State, and no provision of the certificate of incorporation or the bylaws may prohibit bringing such claims in the courts of this State.

“Internal corporate claims” means claims, including claims in the right of the corporation, (i) that are based upon a violation of a duty by a current or former director or officer or stockholder in such capacity, or (ii) as to which this title confers jurisdiction upon the Court of Chancery.”

Thus, the General Assembly codified *Chevron’s* holding that a Delaware corporation can mandate exclusive jurisdiction in Delaware over “internal corporate claims,” defined to encompass claims covered by the internal-affairs doctrine.” There statute made no mention of securities claims arising out of Section 11 of the ’33 Act.

Relying primarily on *Chevron* and Section 115 of the DGCL, VC Laster found that Section 11 claims clearly are external to the corporation and do not relate to its internal affairs. Thus, the defendant corporation’s attempts to mandate federal jurisdiction for Section 11 claims were held to be invalid, and plaintiff’s motion for summary judgement was granted.
How To Deal with State Court Jurisdiction over Section 11 claims?

There is an obvious solution when considering how to deal with the situation going forward: Congress can solve the situation by amending SLUSA to provide for exclusive federal jurisdiction over Section 11 class actions. But will it do so? Is there enough “pro-corporate” sentiment in D.C. to support such a move? And even assuming there is, will this Congress consider such a provision when there are so many other things on its plate? These are not questions that can be answered here, and only time will tell if such an amendment surfaces.

Meanwhile, the resulting risk-allocation decisions are seemingly left in the hands of the corporate issuers themselves (and, to a large extent, their boards of directors or private equity sponsors (where applicable)). Will they decide to accept the balance sheet risk of potentially facing class actions in both state and federal courts, with similar or overlapping allegations of IPO-related securities violations being litigated in multiple venues? And how will the issuers deal with the related risk that their underwriters might be sued as well, implicating the issuer’s general indemnification obligations in connection with the IPO?

These questions are addressed more readily than the Congressional ones because the answer is suggested by historical practice: corporate issuers have tended to deal with such risks by purchasing D&O insurance that covers both the entity and the affected individuals (on a primary basis and an excess Side A basis, the latter of which covers losses that a company is either unable to indemnify or not permitted to indemnify under its certificate of incorporation or bylaws).

There are several considerations with that approach, including:

1. Shareholder lawsuits have become much more expensive to settle over the past few years, especially including Section 11 claims. Are corporations buying enough coverage in a tower of insurance to address all potential liabilities arising out of an IPO (including underwriter liability if that coverage is sought within the company’s D&O coverage)?
2. D&O premiums have gone up over the past two years in response to this trend of increasing settlement amounts. Will D&O rates continue to rise, placing even more pressure on corporate expenses.

3. Pending a SLUSA amendment that provides an exclusive federal forum for Section 11 claims, will D&O carriers be willing to provide greater limits of liability for IPOs — or even any limits of liability at all— knowing that costs and settlement amounts are likely to keep increasing over time?

This is certainly a conundrum, and it presents a unique problem for corporations and their private equity sponsors who are seeking to go public or to issue shares in a secondary offering. While we cannot predict how/whether those involved will exercise their business judgment in making these decisions, it seems clear that the affected directors and officers will want more protection through increased D&O insurance, balance sheet coverage, or both. Indeed, our decades of experience representing directors and officers suggests that the only real questions are how much IPO-related coverage will cost and how much the corporations will be willing to pay for that protection.

In our minds, at least, there is no doubt that the directors who sign registration statements will continue to ask, “Am I covered?” And they should. It is never certain how an IPO will perform, the economy tends to be more uncertain than not, and it is no fun to be a defendant in a securities fraud-related action (or any securities action) — especially if the issuing company goes bankrupt and/or the balance sheet is otherwise unavailable for indemnification obligations.

Ultimately the answer may be that issuers and private equity sponsors are going to need to pay higher premiums to buy the necessary coverage for potential IPO-related liabilities. And that answer leads to a related question: will carriers want to provide the coverage limits requested for IPOs? The market right now is very tight, and even before the Blue Apron decision many D&O carriers have indicated that they just don’t want to play in the IPO space.

We have seen this dynamic before, including during the Financial Crisis when the market for financial services companies was tight to “very tight” given the losses during that period. These things have a way of working themselves out in the market, which can reflect a cause-and-effect relationship. If
corporations need (or must have) the coverage because their directors are requiring it, then they will likely accept higher premiums. And those higher premiums may in turn draw more carriers into the market if they are convinced that they can write that business profitable given the increasing settlement amounts.

As they old adage goes, it is not over until “the fat lady sings.” We will see what tune directors and officers sing going forward, how the carriers respond, and whether Congress can be convinced to act following the Blue Apron decision.

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Alphabet Board Hit With Derivative Suits Over Alleged Sexual Misconduct at Google

By Kevin LaCroix on January 13, 2019
Posted in Director and Officer Liability

In the now more than a year since the #MeToo phenomenon first arose, there have been a number of D&O lawsuits filed against companies and their boards in which the plaintiffs allege that company officials either allowed the alleged sexual misconduct to take place or turned a blind eye. In the latest D&O lawsuits to follow in the wake of allegations of sexual misconduct, two Alphabet shareholders have filed separate derivative lawsuits in California state court against the company’s board based on underlying allegations of alleged sexual misconduct at the company’s Google unit.

The complaint in Northern California Pipe Trades Pension Plan v. Hennessey, et al. (the “Northern California Pipe Trades action”), filed in San Mateo County Superior Court on January 9, 2019, can be found here. The complaint in Martin v. Page, et al, (the “Martin action”), filed in San Mateo county on January 10, 2019, can be found here.

Both of the lawsuits assert claims against to Board of Alphabet for Breach of Fiduciary Duty, Unjust Enrichment, and Corporate Waste, among other things. The complaints allege that the company maintained a “culture of concealment” that led the defendants “in pursuit of their own interests, to participate or acquiesce in the cover-ups of a long-standing pattern of sexual harassment and discrimination by high-powered male executives.” The company’s alleged “pattern of concealment”
allegedly was “intended to protect the Company’s top earning executives and the Board” at the expense of the company’s shareholders and employees.

Both complaints refer extensively to the revelations about alleged sexual misconduct at the company involving the former Google executive, Andy Rubin, known as the father of Android, and two other male Google executives, in an October 25, 2018 New York Times article (here). The Times article claimed that while senior Google executives were aware of the misconduct allegations and had determined that the allegations were credible, the company did not fire the executives for cause, but rather gave the men what one of the complaints alleges were “significant and wasteful exit packages” and hid the “true reasons for their departures” – in Rubin’s case, the 2014 exit package reportedly was worth $90 million. (Some of the allegations against Rubin are quite disturbing and include among other things, allegations that he engaged in human trafficking.)

The media reports of sexual harassment and other misconduct led to a mass walkout of Google employees around the globe on November 1, 2018, as discussed in a Wall Street Journal article at the time (here). Among other things, the employees protested the company’s allegedly inadequate approach to sexual harassment and discrimination in the workforce.

The Northern California Pipe Trades Pension Plan complaint alleges that Alphabet is a “male-dominated company” with a “male-dominated culture” and that the company’s management fostered a “brogrammer culture” in which women were harassed and valued less than their male counterparts.

The Martin complaint alleges that the company maintained a “dual and contradictory standard,” under which, if you were a high level male executive producing significant revenue, the company would “let you engage in sexual misconduct” and if caught allow you to resign with millions in severance; while, if you were a lower level employee and engaged in the same misconduct, you were fired, which allegedly allowed the company to “maintain optics and superficial compliance” while at the same time “concealing the blatant and widespread sexual harassment by senior Google executives.”
The company’s Board, the Martin complaint alleges, allowed the “illegal conduct to proliferate and continue” and that the Board members were “knowing and direct enablers of the sexual harassment and discrimination.” The Martin complaint emphasizes that “this is not a ‘failure to supervise’ case”; rather, the Complaint alleges, the Board was “directly involved in and approved” the severance payments, and “made a conscious and intentional (and bad-faith) decision to conceal the sexual harassment at Google, thereby also breaching its duties of candor and good faith.”

In addition to the sexual misconduct and harassment allegations, the Northern California Pipe Trades Pension Plan complaint also alleges gender disparity for compensation and advancement within Google. The complaint alleges that the company’s culture “limits the opportunities for women” and that the company has been accused in a separate pending class action lawsuit of “persistently discriminating against women” by, among other things, “assigning them jobs in lower compensation ‘band’s than similarly situated men, promoting women more slowly and at lower rates than similarly situated men, and simply paying women less.”

In addition to allegations based on alleged sexual harassment and sexual discrimination, the Northern California Pipe Trades Pension Plan complaint also refers to the data privacy breach that exposed over the personal data of 500,000 Google+ users. The complaint alleges that the company and the board “hid the breach from the public and from Alphabet shareholders.” The Google+ data breach and alleged concealment already is the subject of a securities class action lawsuit, as discussed here.

The complaints allege that the Board’s conduct in allowing this corporate culture has damaged the company in terms of the exit packages the company has paid, which cost the company millions of dollars, exposed the company to litigation, and created a “toxic work environment” that can impact the company’s “ability to hire and retain top talent.” The California Pipe Trades Pension Plan complaint also alleges that the Google+ data breach and concealment has cost the company business and resulted in the loss of goodwill as well as damage to its reputation.

Both complaints allege that the making of a litigation demand on the company’s board is excused as futile because of the board’s likely liability; because of the absence of sufficiently independent board
members; and because the board members are “beholden” to the company’s most senior executives, Sergey Brin, Larry Page, and Eric Schmidt.

The complaints seek recovery of damages, as well as the institution of internal control and corporate governance changes to comply with applicable laws and to avoid a repeat of the alleged damaging events, as well as a disgorgement from the defendants of alleged benefits they received.

Discussion

Though there previously have been a number of #MeToo related D&O lawsuits filed, a number of people recently have said to me that they think this phenomenon of D&O lawsuits based on sexual misconduct allegations would prove to be short-lived and that it has in fact already started to dwindle out. I am not so sure. Among other things, misconduct allegations continue to surface.

In addition, there is an aspect to at least one of these lawsuits that I think we could well see more of. The Northern California Pipe Trades Complaint not only refers to sexual misconduct involving Google executives, but also refers to the sexual discrimination in the male-dominated company culture that the complaint alleges has resulted in gender based pay and advancement disparity. The shareholder derivative lawsuit filed last summer against Nike (discussed here) raised similar gender disparity allegations. The issue of gender-based pay disparity is an arguably related but different issue than the kinds of over sexual misconduct and harassment issues on which many of the #MeToo-related D&O lawsuits are based.

If the focus of the #MeToo social media movement were to move more generally from the sexual misconduct-type allegations and more toward gender based pay and advancement disparity, the wave of revelations could sweep much more broadly and the scope of the follow-on litigation could expand significantly as well.
There is another aspect of the new lawsuit against Alphabet that is also worth noting. Both of the complaints refer to a toxic male-dominated culture at Google, but both complaints also note that “brogrammer culture” at the company is not found just at Google; the complaints allege that in this respect, Google is “like the tech industry at large.” To be sure, Google has been the subject of adverse publicity and its huge payouts to departing company executives make the company a target. But the implication is that the toxic conditions at Google can be found at other tech companies – which in turn suggests that other tech companies also could find themselves the target of this kind of litigation.

All of which makes me thing that while these new complaints against the Alphabet Board may be the latest example of this kind of #MeToo-related D&O lawsuit, it surely will not be the last example of its type.
Dismissal Motion Denied in Sexual Misconduct-Related Securities Suit

By Kevin LaCroix on December 12, 2018
Posted in Securities Litigation

One of the things that has happened in the wake of revelations of high-profile sexual misconduct as part of the #MeToo movement has been the rise of D&O litigation following after the revelations. However, this type of sexual misconduct follow-on litigation didn’t start with the rise of the #MeToo movement. Even before the #MeToo movement there were D&O lawsuits arising from sexual misconduct allegations. One of these earlier cases involved the retail jewelry chain Signet Jewelers. On November 26, 2018, Southern District of New York Judge Colleen McMahoon denied the defendants’ motion to dismiss in the case, in a ruling that may provide an interesting perspective on the many subsequent #MeToo follow on lawsuits. The November 26, 2018 opinion in the case can be found here.

Background

Signet Jewelers is in the retail jewelry business, selling jewelry through several different branded stores, including its Kay Jewelers, Jared the Galleries of Jewelry Stores, Zales the Diamond Stores brands. On August 25, 2016, a plaintiff shareholder first filed a securities class action lawsuit in the Southern District of New York against Signet Jewelers and certain of its directors and officers, as discussed here.

In a subsequent amended consolidated complaint (here), the plaintiffs asserted their claims against the defendants relating to two sets of alleged misrepresentations. The amended complaint alleges that
Signet made material misrepresentations or omissions relating to the health and management of its credit portfolio and with respect to Signet’s alleged corporate culture of sexual harassment. The defendants filed a motion to dismiss the plaintiffs’ complaint.

The Underlying Allegations of Sexual Misconduct and the Allegedly Misleading Company Disclosures

With respect to the allegations based on the alleged culture of sexual harassment, the plaintiffs allegations related to the company alleged disclosures concerning an underlying employment practices class action lawsuit that previously and separately been filed against the company in the Southern District of New York. This prior litigation is referred to as the Jock litigation (in reference to the name of the first-named plaintiff in the lawsuit).

The complaint alleges that Signet first disclosed the Jock litigation in an SEC filing in March 2008, in which the company said that the lawsuit is based on the allegations of 15 former and current employees. In subsequent disclosures, the company said that the lawsuit alleged store-level employment practices that allegedly were discriminator as to compensation and promotional activities.

Initially, the allegations in the Jock lawsuit were not publicly available due to court-required redactions and a seal of the court record. However, when the plaintiffs moved for class certification in the Jock lawsuit and the more than 250 declarations of more than 200 company employees became available in the public record, as least in part, it first became apparent that the lawsuit included allegations of sexual harassment, which, rather than being confined to store-level employees, was “rampant at Signet at all levels, including among senior executives.”

A February 27, 2018 Washington Post article (here) detailed the newly revealed allegations in the employees' declarations, including allegations that the ranks of Signet’s executives were filed with “womanizers,” “playboys,” and serial sexual harrassers who “preyed” on female employees. Among other things, the declarations alleged that female employees were proposition to engage in sexual behavior in exchange for employment advancement; those who did so were rewarded with promotions, but those who declined or reported the activity were retaliated against. Specific allegations of sexual misconduct were alleged against the company's then-CEO.
The November 26, 2018 Opinion

In his November 26, 2018 opinion, Judge McMahon denied the defendants’ motion to dismiss as to both sets of allegations.

With respect to the plaintiffs’ allegations regarding Signet’s credit portfolio, Judge McMahon concluded that the plaintiffs had sufficiently alleged that the company’s statements about its credit portfolio were misleading. He also held that the plaintiffs had sufficiently alleged scienter and loss causation.

In ruling on the sexual misconduct disclosure allegations, Judge McMahon said that the defendants were obligated under their reporting duties to provide a brief but accurate “description of the factual basis alleged to underlie the claims” in the Jock litigation. He said that the plaintiffs had “adequately alleged that Defendants did not do that.”

Judge McMahon specifically noted that the company had said in its SEC reports that the Jock litigation involved store-level alleged misconduct involved alleged discrimination in compensation and promotional opportunities, whereas, the plaintiffs had alleged, the allegations in Jock were about “pervasive sexual harassment that reached the highest offices in the company.” These allegations, Judge McMahon said, “suffice to state a claim that Signet’s public disclosures regarding the Jock litigation were false or misleading.”

Judge McMahon also found that the plaintiffs’ allegations based on the company’s disclosures relating to its Code of Ethics were also sufficient, noting that “statements contained in a code of conduct are actionable where they are directly at odds with the conduct alleged in the complaint.”

However, he said, the plaintiffs had not adequately alleged that the defendants’ generalized statements touting the importance of Signet’s relationship with its employees were materially false and misleading;
these statements, he said, are the sort of “broad, aspirational and vague puffery statements that no reasonable investor could possibly consider in making investment decisions.”

Finally, Judge McMahon concluded with respect to the sexual misconduct disclosure allegations that the plaintiffs had adequately pled scienter and loss causation.

With respect to scienter, Judge McMahon noted that senior management, including one of the named defendants, were implicated in the very sexual misconduct alleged in the Jock case. Judge McMahon said that the plaintiffs had adequately alleged that the defendants “either had present knowledge or were reckless at the misleading nature of their disclosures regarding Jock and their corporate policy against sexual harassment.” He added that the inference of scienter “is at least as compelling as the one that Defendants offer – that their disclosures were in good faith.”

Discussion

One specific thing Judge McMahon said at the outset of her opinion is worth highlighting here. She opened her opinion by saying the securities lawsuit against Signet “is a garden variety securities fraud lawsuit.”

I believe this is important and worth emphasizing because I think some D&O underwriters and even some insurance company claims representatives get confused about these kinds of cases. They look at the underlying employment practice misconduct allegations and think that these cases are EPL cases. To be sure, the underlying lawsuit here (the so-called Jock litigation) is indeed an EPL lawsuit. But the securities lawsuit is not an EPL lawsuit, it is a “garden variety” disclosure lawsuit, the very kind of lawsuit that a public company D&O insurance policy is designed to address.

As I noted above, this lawsuit was first filed before the #MeToo phenomenon really got going, but even though it predated the phenomenon, it is very much a part of the same sensation. There are a couple of things that are important to note in that regard.
While some of the #MeToo follow-on D&O lawsuits have been filed as shareholder derivative lawsuits, others have been filed as securities class action lawsuits (refer, for example, here). Judge McMahon’s ruling shows that plaintiff shareholders can in fact plead a misrepresentation lawsuit based on underlying allegations of sexual misconduct. In other words, these kinds of lawsuits are not merely mismanagement lawsuit; they can in fact be misrepresentation lawsuit, as this case establishes.

The allegations against the company and its executives that have come to light in the Jock lawsuit are indeed troubling, if true. But it is not those allegations alone that allowed the plaintiff shareholders’ securities lawsuit to survive the motion to dismiss. It is not what is alleged in the Jock lawsuit that allowed the plaintiffs here to avoid dismissal; it is what the company itself said in its SEC filings about the Jock lawsuit that allowed the motion to dismiss to be denied.

As is so often the case, the way the company deals with bad news can itself be the source of securities liability. In essence, the plaintiff shareholders allege that the company tried to soft-pedal the seriousness of the allegations in the Jock lawsuit, and that, the plaintiffs allege, is what harmed their investment interests when the alleged truth later came to light. All of which is a reminder of the importance for companies of the way in which they communicate with the investment public regarding negative developments involving the company.

The bottom line for the claimants in other securities class action lawsuits that have been filed on the bases on allegations involving underlying alleged sexual misconduct is that, as this case shows, it is possible to establish a viable securities misrepresentation claim based on company disclosures relating to the alleged misconduct.

The claimants in the other cases may find Judge McMahon’s statements about the plaintiffs’ allegations here based on the company’s code of conduct particularly helpful. Many of the securities suits based in reliance on allegations of underlying sexual misconduct include allegations based on supposed misrepresentation in the company’s disclosures about its code of conduct. Judge McMahon specifically held that these kinds of allegations can be sufficient to state a claim. Claimants in other cases will find
Judge McMahon’s conclusion that statements in a code of conduct can be actionable where they are directly at odds with the conduct alleged in the complaint to be helpful.

In a recent conversation, I was asked whether I think the #MeToo phenomenon had run its course, and whether we would see fewer of these kinds of D&O claims in the future as a result. I happen to think that, unfortunately, we will continue to see high-profile allegations of misconduct. However, I think the direction of the phenomenon and the kinds of misconduct alleged may change.

The one thing I know for sure is that the #MeToo movement has been very empowering for many women, particularly younger women. The message that women can do something when they are treated improperly is powerful. I believe that the kind of issues that women will challenge will move on from sexual misconduct to issues of gender equity, including in particular gender pay disparity. And so, no, I don’t think the #MeToo phenomenon has run its course, I just think the nature of the revelations and of the follow-on D&O litigation will change.
Nike Board Hit with Sexual Misconduct-Related Derivative Suit

By Kevin LaCroix on October 30, 2018
Posted in Director and Officer Liability

In the latest example of a D&O lawsuit following in the wake of allegations of sexual misconduct, three shareholders have filed a state court derivative lawsuit in Oregon against Nike’s Board of Directors alleging that the defendants failed in their oversight duties and allowing a toxic “boys club” culture of sexual harassment and bullying to take hold. The Nike complaint shows yet again that the accountability process that has emerged as part of the #MeToo movement in many cases has involved efforts to hold company’s boards accountable for permitting misconduct or turning a blind eye. The Nike derivative complaint can be found here.

Reports of sexual harassment and sexual discrimination at the Oregon-based athletic shoe company began circulating earlier this year. A March 15, 2018 Wall Street Journal article reported that the company had received complaints about inappropriate workplace behavior, and that the company’s No. 2 executive, Trevor Edwards had resigned. Later articles reported on departures of other executives. Among other things, the reports included allegations that Edwards had fostered an atmosphere where men inside his “boys club” prospered and advanced, while female employees received lower compensation and were passed over for promotions.
In August 2018, two former Nike employees filed a federal court class action lawsuit accusing the company of pay inequity and gender discrimination. Among other things, the plaintiffs complained about the company’s corporate culture, which they said “devalues and demeans its female employees.” The suit charges that Nike has “perpetuated gender-based pay disparities” for years.

On August 28, 2018, three Nike shareholders filed a shareholder derivative lawsuit in Multnomah County Circuit Court against the company’s board and Edwards. (The defendants named in the suit did not include director Cathleen Benko, who joined the board after the reports of misconduct began to surface.)

The shareholder complaint alleges that the company’s “boys’ club” culture resulted in “bullying, sexual harassment and gender discrimination of the Company’s female employees” and that the board and numerous company officers “engaged in, facilitated, and knowingly ignored the hostile work environment” that both harmed the company’s financial position and its reputation. The complaint alleges further in the “boys’ club” atmosphere, “women were excluded from promotions and leadership opportunities.” Edwards, according to the complaint, was one of the “ringleaders,” but instead of being fired for cause, he was enriched by tens of millions of dollars.

The board, the complaint alleges, “repeatedly turned a blind eye to the long-standing culture of harassment and discrimination,” and failed to investigated allegations of sexual harassment and discrimination; failed to prevent management from harassing and discriminating against female employees; and failed to act to improve its policies and procedures or to implement adequate internal controls and reporting programs to prevent the creating and maintenance of a hostile work environment.

The complaint asserts claims against the board for breach of fiduciary duty and waste of corporate assets, and against Edwards for unjust enrichment. (The complaint alleges that between 2015 and 2018 Edwards received total compensation of over $26 million, and that on his departure Edwards was to receive a $525,000 payout and unvested stock award of $9 million.) The complaint seeks damages from the board of not less than $10 million, and from Edwards of not less than $10 million. An unusual
feature of the lawsuit is that large sections of the complaint are heavily redacted; in some cases including entire paragraphs are blacked out, apparently at the request of Nike itself.

Discussion

As I noted at the time, there have been prior D&O lawsuits filed against company officials in the wake of allegations of sexual harassment or discrimination. For example, over the summer, a plaintiff shareholder filed a securities class action lawsuit against CBS following revelation of allegations of sexual misconduct against the company’s CEO. Other companies hit with D&O lawsuits arising out of sexual misconduct allegations include Papa John’s International (here); National Beverage Corp. (here); Wynn Resorts (here); and 21st Century Fox (here).

However, the Nike lawsuit arguably differs in certain respects from the other D&O lawsuits filed after revelations of sexual misconduct. In the prior cases, the alleged underlying misconduct involved alleged instances of unwanted advances, inappropriate touching, and the use of corporate power to try to extract sexual favors. The allegations at Nike are more in the nature of hostile work environment. In both cases, the women who were the victims were demeaned and disadvantaged; but the allegations at Nike do not turn so much as the other cases on specific allegations of unwanted sexual advances or inappropriate touching.

In this instance, the process of holding the company and its executives accountable for permitting or turning a blind eye to the toxic corporate culture includes not only a lawsuit filed on behalf of the persons who suffered directly from the hostile work environment but also a lawsuit filed by company shareholders alleging that the company’s directors failure in their oversight duties harmed the company.

The fact that this D&O lawsuit arose in the wake of hostile workplace environment allegations suggests that the possibility of these kinds of lawsuits may reach more broadly than just companies where executives engage in unwanted sexual advances and sexual contact. Indeed, the allegations that the board failed in its oversight duties by permitting pay inequity and inequities in advancement and promotion suggests the possibility that the potential liability exposure could sweep much more broadly.
As numerous publications have noted in recent days, the #MeToo phenomenon recently passed its first anniversary. However, recent developments suggest that this story will continue to unfold. The recent Kavanaugh confirmation created a great deal of debate and controversy but also suggested that revelations of sexual misconduct will continue to emerge. Indeed, just last week the New York Times ran a front page article detailing the controversy at Google after reports that company executives who faced sexual harassment or discrimination allegations had left the company with sizable payouts. As these stories continue to emerge, we are likely to continue to see D&O lawsuit filed involving the revelations in at least some instances.

One final note about the Nike lawsuit. The first named plaintiff is a Nike shareholder named Shiva Stein. Stein is something of a frequent filer. In a story about the Nike lawsuit (here), the Oregon Business News referred to Stein as a “serial litigant” who has made a “cottage industry” out of suing companies. Among the companies she has sued are Goldman Sachs (here), Live Nation (here), Ampio (here), and Flowserve (here). I am not aware of any study specifically tallying how many lawsuits Stein has filed, but I am certain it is many dozens, many filed by the same small set of plaintiffs’ law firms. This is the kind of thing that drives many business groups and litigation reform advocates crazy. The frequency with which Stein’s name appears at the top of the masthead on civil lawsuit complaints and the frequency with which she is represented by the same set of plaintiffs’ firms does raise questions whether the lawsuits themselves represent something other than an actual effort by an aggrieved party seeking redress.

Special thanks to loyal reader Jim Blinn of Advisen for alerting me to the Nike lawsuit.
Yahoo settles Data Breach-Related Securities Suit for $80 million

By Kevin LaCroix on March 5, 2018
Posted in Securities Litigation

The newly disclosed $80 million settlement of the Yahoo data breach-related securities class action lawsuit will not make the list of the Top 100 securities suit settlements, but it is significant in its own way just the same. Because the settlement is the first substantial data breach-related shareholder lawsuit recovery, it represents a milestone development in a number of respects, as discussed below. The parties’ March 2, 2018 Stipulation and Agreement of Settlement can be found here.

Background

As discussed in detail here, Yahoo announced two data breaches during 2016. The first, which Yahoo announced in September 2016, took place or at least began sometime during 2014, and resulted in hackers obtaining data from over 500 million user accounts. A separate data breach, which apparently took place or began during 2013 but that Yahoo first announced in December 2016, affected over 1 billion user accounts. The Yahoo data breaches are believed to be the largest in history.

As I noted in a blog post at the time, in January 2017, shareholders filed the first of several securities class action lawsuits against Yahoo and certain of its directors and officers in the Northern District of California. In their January 24, 2017 press release (here), the plaintiff’s lawyers state that the complaint alleges that Defendants made false or misleading statements or failed to disclose that:

https://www.dandodiary.com/2018/03/articles/securities-litigation/yahoo-settles-data-breac...
(i) Yahoo failed to encrypt its users’ personal information and/or failed to encrypt its users’ personal data with an up-to-date and secure encryption scheme; (ii) consequently, sensitive personal account information from more than 1 billion users was vulnerable to theft; (iii) a data breach resulting in the theft of personal user data would foreseeably cause a significant drop in user engagement with Yahoo’s websites and services; and (iv) as a result, Yahoo’s public statements were materially false and misleading at all relevant times.

The complaint alleges that following the company’s September 2016 disclosure, the company’s share price declined 3.06%. The complaint alleges that following the company’s December’s 2016 data breach disclosure, the company’s share price declined 6.11%.

The complaint also referenced Yahoo’s July 25, 2017 announcement that it would be selling its core business to Verizon Communications. The complaint alleged that following the company’s December 2016 data breach disclosure, “several news sources reported that Verizon was considering ways to amend the terms of its deal with Yahoo to reflect the impact of the data breach and would likely seek ‘major concessions’ from Yahoo.” In February 2017, Verizon announced that as a result of the data breach news, it was cutting $350 million from the price it would pay for the Yahoo acquisition. Verizon completed the deal in June 2017.

Finally, the complaint also referenced news articles (here) reporting that the SEC had opened an investigation into the timing of Yahoo’s disclosures regarding the data breach.

The court consolidated the various complaints and the defendants filed a motion to dismiss. As detailed in Judge Lucy Koh’s November 22, 2017 order (here), while the dismissalal motions were pending, the parties engaged in settlement negotiations. In her order, Judge Koh dismissed the motions as moot and gave the plaintiffs leave to file an amended complaint. The plaintiffs subsequently filed an amended complaint, while the negotiations continued. On March 2, 2018, the parties advised the court that they had reached a settlement.
The Settlement

Interestingly, though the parties had filed their settlement stipulation, Yahoo apparently also filed a motion to dismiss the plaintiffs' second amended complaint with the court on March 2. Law 360 reports that "lead plaintiff Ben Maher had apparently refused the settlement. Attempts to contact Maher on Monday were not immediately successful."

The settlement was reached on the defendants' behalf by Altaba, an investment company holding certain former Yahoo assets as a result of Verizon's acquisition of Yahoo. The settlement stipulation refers to Altaba as being "formerly known as" Yahoo. In the settlement stipulation, the defendants expressly deny liability.

The stipulation of settlement does not say anything about how the settlement amount is to be funded or whether D&O insurance will pay some or all of the settlement amount. The settlement stipulation says only with respect to the payment of funds that Yahoo will pay the settlement or cause it to be paid. The list of Released Defendant Persons that the plaintiffs agree to release in the settlement expressly includes defendants' insurers (not an unusual provision). In the provisions of the settlement stipulation describing the way in which the settlement will be funded and the timing, the stipulation states that the settlement consideration will be paid only after, inter alia, the provision of "other information or authorizations that may be required by certain of Altaba's insurance carriers" – which certainly suggests that D&O insurance is playing a role in funding the settlement.

Discussion

There have been a number of high profile shareholder lawsuits filed against companies that had experienced data breaches. However, while these cases were filed, they did not turn out to be all that productive from the plaintiffs' perspective. Indeed, several high profile data breach shareholder derivative lawsuits were dismissed. (As discussed here, one of these cases, involving Home Depot, settled for a relatively modest amount in May 2017 while the dismissal was on appeal).
Despite these early setbacks in the shareholder derivative suits, in 2017, plaintiff shareholders filed a number of new data breach-related securities suits – though the 2017 suits were filed as securities class action lawsuits rather than as derivative suits. The Yahoo data breach-related securities suit was the first of these newer cases to be filed; it was followed by several other data breach related securities suit filings later in the year, including the high profile securities suit filed against Equifax.

Even when the plaintiff shareholders met with the prior disappointment in the derivative lawsuits, it seemed unlikely that the plaintiffs’ attorney would simply abandon the effort to try to pursue data breach related D&O claims. Rather, it seemed as if the plaintiffs’ lawyers had simply not yet found the way that they were going to make money on these kinds of claims.

Now with the Yahoo settlement, it seems like the plaintiffs’ lawyers may have achieved an advance of sorts. At a minimum, it certainly shows that the plaintiffs’ lawyers might actually be able to make money on these kinds of lawsuits. (The plaintiffs lawyers reportedly intend to seek attorneys’ fees of up to $20 million from the court.) The magnitude of the settlement, by contrast to the outcome in all of the prior data breach-related shareholder lawsuits, may hearten other prospective claimants and plaintiffs’ attorneys as well. For that reason, this settlement represents both something of a milestone and something of a breakthrough.

None of which should be interpreted to suggest that we are about to see a flood of these kinds of cases. There were only a very small number of data breach-related securities lawsuits filed in 2017, even with the Yahoo and Equifax cases. In many instances, companies experiencing data breaches may not necessarily be attractive securities suit case because company share prices often do not drop significantly on news of a data breach. In the absence of a significant stock drop, the data breach company will not be an attractive securities suit target.

There are also a number of factors that arguably make the Yahoo situation distinctive, and even perhaps unique. First of all, the data breach was the largest ever. Second of all, the data breach disclosure had a material and readily identifiable financial impact on Yahoo, as it resulted in the $350 reduction of the amount that Verizon was to pay for the Yahoo acquisition. Thirdly, there was the very unusual combination of circumstances in which the massive breaches had taken place years earlier but were not
disclosed until years later. It could be argued that merely because the Yahoo case, with all of these distinctive features, resulted in a significant settlement does not necessarily mean that many other companies will be sued or that the plaintiffs’ lawyers are going to be able to secure significant recoveries in a lot of other cases.

Just the same, the Yahoo settlement (assuming it is approved by the court) is the first significant data breach-related shareholder lawsuit settlement. The plaintiffs’ lawyers have now figured at least one way they can make money off of this type of litigation. Interestingly, this settlement coincidentally comes just days after the SEC released new guidance in which the agency underscored the disclosure obligations of reporting companies that have experienced data breaches. It is hard to know for sure, but it could be this milestone settlement together with the SEC’s new disclosure guidelines could mean that data breach-related shareholder litigation could be an area of increased focus for the plaintiffs’ lawyers.
Yahoo Data Breach-Related Derivative Suit Settled for $29 Million

By Kevin LaCroix on January 21, 2019
Posted in Cyber Liability

In recent years, plaintiffs' lawyers have filed a number of management liability lawsuits against the executives of companies that have experienced high-profile data breaches. These lawsuits have either been filed as shareholder derivative lawsuits or securities class action lawsuits. By and large, the cases filed as shareholder derivative lawsuits have been unsuccessful. However, in a development that represents a milestone in several different respects, the parties to the Yahoo data breach-related derivative lawsuit have agreed to settle the case for $29 million. As discussed below, this settlement may have important implications for future data breach-related derivative litigation. The Court's January 4, 2019 order approving the settlement can be found here (see calendar Line 5 in the order).

Background

In July 2016, shortly after it had entered an agreement to be acquired by Verizon, Yahoo announced the existence of a data breach that had taken place in 2014. The data breach impacted as many as 500 million Yahoo users. On December 14, 2016 Yahoo disclosed that it had been subject to an even larger data breach, involving one billion users, in 2013 which involved sensitive user information, including names, telephone numbers, dates of birth, encrypted passwords. (Yahoo subsequently disclosed that the 2013 breach may have affected all three billion of Yahoo's users.) The two attacks are the largest known security breaches of one company's computer network. Among other things, after Yahoo announced the
data breaches, Verizon and Yahoo's management negotiated a $350 million reduction in Verizon's $4.8 billion acquisition of Yahoo's assets.

A variety of different lawsuits followed these events. Among other things, shareholders filed a securities class action lawsuit against Yahoo and certain of its directors and officers (as discussed further below, the securities lawsuit settled in March 2018 for $80 million). In addition to the securities class action lawsuit, plaintiff shareholders also a number of derivative lawsuits against Yahoo's board and senior managers. The separate lawsuits later were consolidated. The plaintiffs' amended consolidated derivative complaint, which though heavily redacted makes for some very interesting reading, can be found here.

The derivative complaint asserts claims against Yahoo's board for breach of fiduciary duty, insider trading, unjust enrichment, and waste. The plaintiffs also asserted claims against Verizon for aiding and abetting. Among other things, the complaint alleges that Yahoo officials knew about the data breaches long before they were disclosed to the public and that instead of disclosing that the data breaches had taken place the defendants sought to cover up the breaches. The complaint also alleges that several of the individual defendants sold stock from their personal holding of Yahoo stock after becoming aware of the data breaches and before the breaches were made public.

The Settlement

As detailed in the court's order approving the settlement, the parties agreed to settle the derivative litigation for $29 million, the amount to paid by "the insurance carriers of the individual defendants and Verizon, as separately agreed by them." The parties' stipulation of settlement and settlement agreement can be found here. In the settlement, the defendants expressly denied the plaintiffs' allegations of wrongdoing.

The court separately approved the plaintiff's counsel's fee of $8.6 million for the derivative lawsuit, as well as a separate and additional $2 million for the plaintiffs' counsels' effort in connection with proxy litigation (relating to Yahoo's asset sale to Verizon). The remaining roughly $18.4 million will be paid to
Altaba, Yahoo’s successor in interest. The negotiated release in the settlement expressly does not include a release of the pending consumer data breach-related class action pending against Yahoo.

Discussion

As I mentioned at the outset, though there have been a number of high-profile data breach related shareholder derivative lawsuits file over the years, these cases have largely been unsuccessful. During the period 2014-2016, plaintiffs filed shareholder derivative lawsuits against the boards of Wyndham Worldwide, Target, and Home Depot. In each of these cases, the courts granted the defendants’ motion to dismiss, as noted respectively, here, here and here.; in the Home Depot case, while the dismissal was on appeal, the parties agreed to settle the case for defendants’ agreement to pay the plaintiffs’ attorneys’ fees of $1.125 million. In addition, in a separate derivative lawsuit filed against the board of fast food chain Wendy’s, the parties agreed to settle the case while the dismissal motion was pending based on the company’s agreement to adopt a number of remedial measures and the defendants’ agreement to pay the plaintiffs’ attorneys fees of $950,000.

None of these prior cases resulted in significant monetary recoveries – which in and of itself may not be all of that noteworthy, as until quite recently a significant recovery in derivative lawsuits was a relatively unusual event. Just the same, the track record in prior data breach related derivative litigation makes the significant recovery in the Yahoo data breach-related derivative settlement all the more noteworthy.

The Yahoo data breach debacle has led to a number of different milestones in the annals of data breach-related management liability litigation.

As noted here, the parties to the Yahoo data breach-related securities class action lawsuit agreed to settle the case for $80 million.

In addition, in April 2018, Altaba, Yahoo’s successor in interest agreed to pay a penalty of $35 million in resolution of the SEC’s first-ever data breach related enforcement action.
In what is a completion of a trifecta of sorts, the defendants in the Yahoo data-breach related derivative lawsuit have now agreed to settle the case for the payment of $29 million. (In addition, according to news reports, the parties to the separate data breach related consumer class action reportedly have agreed to settle that case for a payment of up to $85 million.)

The Yahoo data breach derivative lawsuit is noteworthy in that it represents the first significant recovery in a data breach-related derivative lawsuit. In that regard, it arguably is particularly noteworthy that the plaintiffs’ lawyers secured a fee of $10.6 million, a recovery that is sufficiently sizeable that it is likely to catch the attention of others and perhaps encourage others to seek to pursue these kinds of cases.

As noted in a January 14, 2019 post on the NACD Board Talk blog (here), the significant cash settlement in the Yahoo data breach-related derivative lawsuit settlement “sets a potentially dangerous precedent for future breach-related derivative actions.” The settlement could, as another commentator noted, “serve as proof of concept to inspire a wave of would-be imitators looking for their own multimillion dollar payday.”

To be sure, there are certain features of the Yahoo situation that may make the circumstances somewhat unique. For starters, it appears to involve the largest ever data breach. There also is the very unfortunate circumstance of the long lag-time between the date of the breach and the time when Yahoo finally got around to disclosing the breach. Moreover, there is the very specific aspect of the case in which Verizon renegotiated the price of its asset acquisition, reducing the value of the deal by $350 million, which represented a very significant and undeniable financial consequence resulting from the data breach. Few other cases are going to involve anything like this combination of circumstances.

Indeed, in light of these factors, it arguably is no surprise that the company and its successor in interest has agree to pay a combination of a total of almost $145 million in settlement of management liability claims and regulatory enforcement actions (and apparently another $85 million in settlement of the consumer liability class action). The magnitude of these settlements directly reflects the egregiousness of
the allegations that have been asserted against the company and its executives in the wake of the data breach revelations.

There have of course been other high-profile data breaches that have captured the headlines in the business pages; some of these data breaches have resulted in management liability actions against the executives at the companies involved. Many of these cases – including the lawsuits involving executives at Equifax and Marriott, for example – remain pending. It remains to be seen whether these cases will result in recoveries of any kind, much less of the magnitude of the recoveries secured in connection with the Yahoo data breach.

While the outcome of the pending cases remains to be seen, the fact is that the significant recovery in the Yahoo data breach derivative suit could well encourage other claimants to file similar lawsuits in the future. As one commentator noted, “executives whose companies experience a data breach could find themselves on the hook for a similarly sizeable amount.”
As I have noted in several recent posts, plaintiffs' lawyers seem to have a renewed interest in trying to pursue securities class action lawsuits against companies that have experienced a data breach. Just to cite one recent example, as discussed here, within a day of Marriott's recent high-profile announcement of a data breach involving its Starwood unit's customer database, plaintiffs' lawyers filed a securities class action lawsuit against the company. While plaintiffs' lawyers may be drawn to these data breach cases, the cases may or may not prove to be successful for them. For example, in a recent ruling in the data breach-related securities class action lawsuit filed against PayPal late last year, the court granted the defendants' motion to dismiss. The ruling highlights many of the problems plaintiffs' lawyers will have in trying to pursue these kinds of cases. Northern District of California Judge Edward Chen's December 13, 2018 ruling in the case can be found here.

Background

The PayPal data breach-related securities lawsuit involved developments at the company following its July 18, 2017 acquisition of bill-payer management company TIO Networks Corp. In a November 10, 2017 press release (here), Pay Pal announced that it had discovered "security vulnerabilities on the TIO platform and issues with TIO's data security program that do not adhere to PayPal's information security standards." (PayPal's network was not affected.) PayPal said it had initiated an internal investigation of TIO and was consulting with third-party cybersecurity experts.
In a December 1, 2017 press release (here), PayPal provided an update on the suspension of operations at TIO. The press release said that as a result of the review of TIO’s network, the company had identified “a potential compromise of personally identifiable information for approximately 1.6 million customers.” The press release also said that the ongoing investigation had “identified evidence of unauthorized access to TIO’s network, including locations that stored personal information of some of TIO’s customers and customers of TIO billers.” On December 4, 2017, the first trading day following the December 1 announcement, PayPal’s share price declined 5.75%.

On December 6, 2017, plaintiffs’ lawyers filed a securities class action lawsuit in the Northern District of California against PayPal, certain of its operating units, and certain of its directors and officers. The plaintiffs contend that the initial release failed to fully disclose the seriousness of the security breach. They contend that the defendants knew there had been an actual security breach before the November 10 press release, but instead referenced only “vulnerabilities.” The omission, the plaintiffs allege, was materially misleading and that the defendants knew the omission was misleading.

The Court’s December 13, 2018 Decision

In a December 13, 2018 Order, Judge Edward Chen granted the defendants’ motion to dismiss. While ruling that the plaintiffs had adequately pled falsity, noting that the plaintiffs had adequately pled that the initial November 10 disclosure “plausibly ... created the impression that only a potential vulnerability and not an actual breach had been discovered, and certainly not one which threatened the privacy of 1.6 million users,” the plaintiffs had not adequately pled scienter.

In ruling on the scienter issue, Judge Chen noted that the plaintiffs had alleged that the public’s awareness of a data breach of 1.6 million customers had caused the 5.75% stock drop. In order to establish scienter, Judge Chen said, the plaintiffs had to show that as of the November 10 disclosure, the defendants knew not only of an actual breach, but that the privacy of 1.6 million customers had been potentially compromised.
In order to try to make this argument, the plaintiffs relied on the supposed testimony of three confidential witnesses. Reviewing the confidential witness statements, Judge Chen concluded that the statements at most establish that some of the defendants may have known that there was some kind of breach in TIO’s platform. None of the confidential witnesses, Judge Chen said, state that the defendants knew on November 10 of the magnitude of the breach affecting 1.6 million customers or even the fact that customers’ personal information had been compromised.

Accordingly, Judge Chen concluded that the plaintiffs’ reliance on the three confidential witnesses’ statements “fail(s) to satisfy the scienter of the falsity upon which their alleged loss is predicated.” Judge Chen also concluded that the plaintiffs had failed to establish control person liability under Section 20, as well.

Discussion

I have to say, this was always going to be a tough case for the plaintiffs, because their theory that the defendants were lying on November 10 before telling the truth on December 1 doesn’t make any sense. Why would the defendants lie on November 10 only to reveal the truth three weeks later? Doesn’t common sense tell you that the defendants first revealed the problem when it was discovered and then revealed how bad it was once they knew how bad it was? The plaintiffs’ version lacks any plausible theory why the defendants would have deceived investors for three weeks but not after that.

Judge Chen’s discussion of the scienter issues here not only shows why the plaintiffs allegations in this case were insufficient, but also shows why plaintiffs’ allegations in many of the other data breach-related securities suits – and indeed in most of the other event-driven securities litigation – are vulnerable to motions to dismiss. Plaintiffs lawyers seem eager to file the data breach cases, and event-driven securities cases generally, but most of the cases, like this case, lack allegations sufficient the scienter pleading requirements.

It is worth noting that this lawsuit, like many of the recent event-driven lawsuits, was filed by one of the very small handful of “emerging” law firms that is responsible for a very significant part of the increased volume of securities class action lawsuit filings in recent months. The fact is that most of the lawsuits
being filed, particularly the event-driven lawsuits, are – like this lawsuit – not very good lawsuits. Indeed, as I have noted before, the whole phenomenon of the event-driven lawsuit filings is one of the significant factors that has recently driven business groups to call for securities litigation reform.

There is one thing worth noting about this lawsuit, and that is the fact that the underlying data breach issues involved an operating division that had recently been acquired by the defendant company, that was discovered after the acquisition was completed. That is more or less what happened at Marriott as well, where the recent data breach issues arose out of the company’s Starwood division, which Marriott had recently acquired. Clearly, data security represents an important vulnerability for M&A activity, a consideration that could have underwriting implications for D&O as well as for Cyber coverages.

Earlier this year, when the $80 million settlement of the Yahoo data breach-related securities lawsuit was announced (as discussed here), I thought the size of the settlement might hearten plaintiffs lawyers and encourage more of them to file data breach-related D&O lawsuits. I believe that has happened, as there have been a number of data breach-related securities suits filings this year. But as the ruling in the PayPal case shows, even if plaintiffs’ lawyers are drawn to these kinds of cases, the suits still have to pass muster. Many of the recent filings – both of the data breach-related cases and of the event-driven securities lawsuits generally – like the PayPal case may not meet the threshold pleading requirements, particularly with respect to scienter.
Marriott Hit with Data Breach-Related Securities Lawsuit

By Kevin LaCroix on December 3, 2018
Posted in Securities Litigation

When news of the recent massive data breach at Marriott began circulating late last week, a colleague emailed and asked me how long I thought it would take for a D&O lawsuit to be filed. I emailed back that I thought there would be a securities class action lawsuit before the end of business on Monday (December 3). Turns out, I didn’t give the plaintiffs’ lawyers nearly enough credit for haste. The plaintiffs’ lawyers managed to file a securities class action lawsuit against the company on December 1, 2018, just one day after Marriott announced the breach. The lawsuit is the latest example both of a data breach-related D&O lawsuit and an event-driven securities suit, as discussed further below.

Background

On November 30, 2018, Marriott issued a press release announcing that hackers had breached its Starwood guest reservation system and stolen the personal data of as many as 500 million guests. The company announced that on September 8, 2018 an internal security tool had alerted the company of attempted unauthorized access. The subsequent investigation of the incident revealed that there had been unauthorized access to the Starwood network since 2014. The investigation revealed that an unauthorized party had copied and encrypted information and had taken steps toward removing the information. On November 19, 2018, the company was able to decrypt the information and determine that the contents were from the Starwood guest database. (Marriott acquired Starwood in 2016 for $13.6 billion.)
In its press release, the company said that the database itself contained information on approximately 500 million guests who had made reservations with Starwood. For about 327 million of the guests, the information includes some combination of name, mailing address, phone number, email address, passport number, Starwood Preferred Guest account information, date of birth, gender, arrival and departure information, reservation date, and communication information. For some guests, the information also includes payment card information including card expiration date, however, the company was not yet able to determine if the payment card information had been decrypted.

The plaintiffs' lawyers did not waste any time in launching lawsuits based on the company's disclosures. On November 30, 2018, the same day that Marriott issued its press release, a plaintiffs' lawyer filed what undoubtedly will be the first of many consumer class action lawsuits. And, as discussed below, on December 1, 2018, plaintiffs' lawyers filed what may prove to be only the first of the D&O lawsuits filed in connection with the breach.

The Securities Class Action Lawsuit

On December 1, 2018, plaintiffs' lawyers filed a securities class action lawsuit in the Eastern District of New York against Marriott; its CEO; its CFO; and its Chief Accounting Officer and Controller. The lawsuit purports to be filed on behalf of a class of persons who purchased their Marriott shares between November 9, 2016 and November 29, 2018. A copy of the plaintiffs' complaint can be found here.

The complaint refers to statements in the company's SEC filings during the class period about the importance of information technology security. The complaint also refers to the company's November 30, 2018 press release. The complaint alleges that this the statements in the company's SEC filings were false and misleading because: “(1) Marriott’s and Starwood’s systems storing their customers’ personal data were not secure; (2) there had been unauthorized access on Starwood’s network since 2014; (3) consequently the personal data of approximately 500 million Starwood guests and sensitive personal information of approximately 327 million of those guests may have been exposed to unauthorized parties; and (4) as a result Marriott’s public statements were materially false and/or misleading at all
relevant times.” The complaint alleges that on the news of the breach of the guest information systems, the company's share price declined 5.5%.

Discussion

Earlier this year, when Yahoo’s successor in interest announced the $80 million settlement of the data breach-related securities class action lawsuit, I speculated that the sizeable settlement (which represented a milestone as the first significant recovery in a data breach-related D&O lawsuit) might encourage other prospective claimants to file data breach related securities suits.

Since then, there have been a number of other data breach-related securities suit filed. For example, as discussed here, in October 2018, a plaintiff shareholder filed a data breach-related securities suit against online educational service provider Chegg, Inc and certain of its executives. A few days later in October, a shareholder of China-based hospitality group, Huazhu, filed a securities class action lawsuit against the company and certain of its directors and officers, as discussed here. In October, a plaintiff shareholder also filed a data security lawsuit against Alphabet related to data security issues in connection with the company's Google+ platform, although that lawsuit did not involve a data breach, as discussed here.

Given the number of securities suits, it is clear that data security issues represent a significant area of D&O exposure. And as I have noted, the advent of the EU's General Data Protection Regulation even further increases this exposure. Indeed, in its article about the Marriott breach, the New York Times quoted one observer as saying that, given the volume and sensitivity of personal data taken, as well as the length of the breach, Marriott “has the potential to trigger the first hefty GDPR fine.”

The Marriott incident is also a reminder that companies remain vulnerable to massive data attacks. As the Times said, in its article about the breach, the intrusion is “a reminder that after years of headline-grabbing attacks, the computer networks of big companies are still vulnerable.” These vulnerabilities suggest we will continue to see data breach-related litigation, including in particular data breach-related D&O litigation.
But while the new securities lawsuit against Marriott focuses on the breach information the company released on November 30, the complaint does not refer to the earlier breach announced at Starwood. As discussed in a December 3, 2018 Wall Street Journal article (here), in 2015, just after its merger deal with Marriott was announced, Starwood announced that it had sustained a data security incident involving a breach of the security in its point of sale system. The Journal article contains statements from several data security commentators to the effect that, though the earlier data breach was unrelated to the more recently announced hack, the investigation into the 2015 hack should have uncovered the larger guest information system breach.

The new complaint also does not refer to the very high-profile data problems Marriott was having with its customer loyalty program, primarily because of difficulties of integrating the Starwood preferred guest information. The company’s data and information technology problems with the customer loyalty program were the subject of a substantial article in the Wall Street Journal earlier last week (here), before the news of the data hack was made public.

While the new lawsuit against Marriott is noteworthy to the extent it represents yet another example of a data breach related securities litigation, it is also noteworthy as the latest example of an event-driven securities lawsuit. As I have noted, plaintiffs’ lawyers have recently filed others of these event-driven lawsuits, for example, in connection with the California wildfires (here) and the Lion Air 610 airliner crash (here).

Like those earlier suits, the new lawsuit does not involve allegations of financial or accounting misrepresentations. Instead, it involves allegations that the company suffered a significant reverse in its operations. In the securities lawsuit, the plaintiffs allege that the company failed to inform investors that the adverse event might occur and that if it did occur it would have a negative impact on the company.

Like the earlier suits, the scienter allegations in the new Marriott lawsuit are not extensive (to say the least). Also the magnitude of the stock price drop, in this suit and in the lawsuit filed against Boeing, is quite slight.
Whatever the merits of these event-driven securities lawsuits, they represent an increasingly important component of securities litigation filing activity, and indeed, represent an important part of the elevated levels of securities suit filings going back into 2016. When the annual securities suit filing tally is put together at the end of this year, when we are looking for explanations for the elevated levels of securities lawsuit filings, one explanation is clearly going to be the willingness of certain segments of the plaintiffs’ bar to file these kind of lawsuits, despite not extensive scienter allegations and only slight stock price drops.

The new Marriott lawsuit has only just been filed, and it remains to be seen how it will fare. I will say that the more of these event-driven lawsuits that are filed, the more people are going to be willing to the recently renewed call for securities class action litigation reform. Indeed, in its recent report calling for Congress to take up securities litigation reform, the U.S. Chamber of Commerce’s report specifically cited event-driven litigation as one of the main reasons why Congress should take up the reform issue, as discussed at length here.
A. POTENTIAL COVERAGE ISSUES ARISING FROM NATURAL DISASTERS

1. WHAT CAUSED THE LOSS?

A ubiquitous issue that arises with respect to natural disasters is how the peril is characterized – is it a hurricane, a “named storm,” a windstorm, a flood, or something else for policy purposes? And what occasioned the particular damage at issue in the insurance claim – wind, wind-driven rain, storm surge, or flood?

How the storm and mechanism of loss is characterized has critical implications for insurance recovery. Policies commonly provide different amounts of available limits (and sub-limits) for different types of losses. E.g., State Farm Florida Ins. Co. v. Moody, 180 So. 3d 1165 (Fla. Dist. Ct. App. 2015) (considering policy that limited coverage for damage caused by “hurricane” but that did not limit coverage for damage caused by “tornado”). And in some cases, policies may not provide coverage at all for losses that occurred as a result of certain causes. E.g., In re Katrina Canal Breaches Litig., 495 F.3d 191, 222–23 (5th Cir. 2007) (considering whether damage to property was caused by flood or by the negligent design and construction of levees; flood being an excluded peril under the policy, while negligent construction was covered). For example, a commercial property insurance policy may provide coverage for damage caused by wind or a named storm but exclude coverage for damage caused by flood. E.g., Bradley v. Allstate Ins. Co., 620 F.3d 509, 519–20 (5th Cir. 2010). To complicate matters further, policies often contain overlapping concepts of what is a “flood” vs. a “named storm,” including, for example, whether storm surge resulting from a named storm is treated as part of the named storm or as a flood.

Property policies purchased by businesses often contain different sub-limits, deductibles, and business interruption waiting periods depending on the cause of loss. The net effect is that the scope and amount of coverage can vary dramatically depending on how the cause of loss is characterized up front to the carrier when the proof of loss is transmitted – a critical juncture that is rarely straightforward and that usually benefits from thoughtful analysis and advocacy on the policyholder’s behalf. To recover what they are fairly owed, policyholders need to have a thorough understanding of the coverage provided under their policies, the relevant case law, and the mechanism or mechanisms that caused their loss.

2. SERVICE INTERRUPTION

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1 This paper is adopted from a paper originally presented at the ABA TIPS Property Insurance Law Committee’s Annual Spring CLE, March 3, 2018 by Geoffrey J. Greeves, Janine Stanisz, Jonathan R. MacBride, Jonathan Held and Jeannie Barker
Assuming there is no physical damage to your premises at all, how can a business function without electricity, telephone, email or water service? Utility service interruption coverage (if purchased) indemnifies, for example, against loss due to lack of incoming electricity affected by damage from a covered cause (fire or named storm) to property away from the insured's premises — usually the utility generating station. This type of insurance is commonly referred to as "off-premises power coverage." Utility service interruption endorsements vary widely as to what utility services may trigger coverage, whether both direct damage and time element loss are covered, and whether “transmission lines” are covered.

Service interruption coverage is not standard, or even common. One type of service interruption coverage provides direct damage coverage while the other affords time element (business income and extra expense) coverage. You can purchase one or both.

Commonly covered off-premises utilities include:

- Water Services — pumping stations and water mains
- Communications Services — property used to supply telephone, radio, microwave or television services. Includes communication transmission lines, coaxial cables and microwave relays.
- Power Services — electricity, gas and steam, utility generating plants, switching stations, substations, transformers, and transmission lines. Typically the policyholder must elect either to include or exclude overhead transmission lines.

The value of goods, including raw goods under refrigeration, is often challenged by the carrier when presented for coverage. The issue is further complicated in large scale operations by several commonly found exclusions that limit the inherent risks associated with perishables, including mechanical defect, failure to maintain systems and consequential losses.

In Prot. Mut. Ins. Co. v. Mitsubishi Silicon Am. Corp., 992 P.2d 479 (Or. Ct. App. 1999), the insured operated a silicon wafer manufacturing plant in Salem, Oregon. The Salem area experienced a severe flood. In response to increased turbidity in its water, the City of Salem shut down its water treatment facility and requested that the insured voluntarily reduce its water consumption. Subsequently, the city of Salem closed its wastewater treatment facility because of the threat of imminent flooding at its plant, which forced the insured to cease most of its operations. The insured incurred a loss of business revenue as well as increased operating expenses. The Policy excluded food and the court determined that there was no coverage for the service interruption because it had been caused by a flood. Even though the policy contained a flood endorsement, the court concluded that endorsement did not extend to the service interruption coverage.

In Pentair, Inc. v. Am. Guarantee & Liab. Ins. Co., 400 F.3d 613, 617 (8th Cir. 2005), the insured’s suppliers were forced to shut down two factories when an earthquake disabled electrical substations servicing the factories. While the policy extended coverage to service interruption regardless of whether it caused property damage, it only covered losses from damage to off-premises power stations supplying power to the “described premises.” Id. Since the supplier’s factories were not “described premises” the coverage did not extend to the service interruption at those factories. Id.
3. CHALLENGES OF PROVING CONTINGENT BUSINESS INTERRUPTION LOSS

“Contingent business interruption” coverage – which covers a loss in the policyholder’s income due to damage to the property of the policyholder’s suppliers or customers – is one of the most common and important coverages in the aftermath of a catastrophe given the far-reaching impact of the catastrophe. But proving the loss that pivots on the impact to customers and suppliers is challenging and policies generally offer little guidance on how to prove contingent losses.

In *Pentair, supra*, the court held that the electrical substations supplying electricity to Pentair’s suppliers were not “a supplier of goods and/or services” to Pentair. *Id.* at 615. While Pentair had tried to rely on *Archer-Daniels-Midland Co. v. Phoenix*, 936 F.Supp. 534 (S.D.Ill.1996), to argue that the electrical suppliers were indirect suppliers of Pentair’s, the court was not persuaded. In *Archer Daniels* the court had found that farmers supplying grain to a middle man, were suppliers of the insured. However, the court distinguished *Archer Daniels*, because the insured in that case had incorporated the grain produced by the farmers into its product, whereas the electrical suppliers did not do not supply a product or service ultimately used by Pentair. *Id.* Therefore it supplied no goods or services to Pentair, directly or indirectly.

In a natural disaster, the breadth of the policy language providing the CBI coverage and the connection between the damage property and the insured’s business will be critical to the analysis of coverage.

4. COVERED AND NON-COVERED PERILS

Given that property policies may provide coverage only for certain causes of loss, or may provide different amounts of coverage depending on the cause of loss (e.g., named storm vs. flood), a contentious issue for policyholders and insurers will be the extent to which a loss is covered when it is caused concurrently or sequentially by both covered and non-covered perils. Courts in different jurisdictions have adopted various approaches to resolve this issue.

Some courts apply an “efficient proximate cause” test, under which a dominant cause is determined and coverage hinges upon whether that cause is covered, or alternatively whether the covered cause set the chain of events in motion. Other courts apply one of two “concurrent cause” analyses – (1) some courts have ruled that when two causes combine to produce an indivisible loss, there is coverage as long as one of the causes was a covered peril under the policy, and (2) other courts have ruled that the policyholder bears the burden of differentiating damage attributable to covered and non-covered causes, and if the policyholder cannot meet that burden there is no coverage.

Some courts have held that coverage may be excluded in certain circumstances when covered and excluded events combine to cause a loss, see *JAW The Pointe, L.L.C. v. Lexington Ins. Co.*, 460 S.W.3d 597, 608 (Tex. 2015) (coverage is barred when “‘excluded and covered events combine to cause’ a loss and ‘the two causes cannot be separated’”), whereas recent Florida authority supports that there is coverage in such a situation. *Sebo v. Am. Home Assurance Co., Inc.*, 208 So. 3d 694, 700 (Fla. 2016) (noting that “it seems logical and reasonable to find the loss covered by an all-risk policy even if one of the causes is excluded from coverage”).
This analysis turns on the policy language as well. Insurers have sought to eliminate coverage in instances involving concurrent causes by incorporating “anti-concurrent causation” language in their policies that purports to bar coverage when an uncovered cause is involved in any way, whether directly or indirectly. For example, the policy may state: “We will not pay for loss or damage caused directly or indirectly by any of the following. Such loss or damage is excluded regardless of any other cause or event that contributes concurrently or in any sequence to the loss.” Some courts have enforced these anti-concurrent cause provisions while others have held that they are unenforceable, predominantly on public policy grounds. Where and how this language appears in the policy is also important and factors into how a court will view it. If the language is buried deep in a definition or an exclusion, for example, the situation might be distinguishable from existing case law.

The Florida Supreme Court in Sebo v. Am. Home Assurance Co., 208 So. 3d 694 (Fla. 2016) formally adopted the concurrent causation doctrine as it relates to determination of coverage for damage caused by multiple perils under a first-party insurance policy. In Sebo, the insured sought coverage for water damage that was caused when water entered the home as the result of construction defects. The home ultimately had to be demolished as a result of the water damage.

The court found that the insured’s claimed damage combined in such a way that it was impossible to discern the proximate cause of the property loss – i.e., the rain and construction defects acted in concert to destroy the insured’s home. The court further held that it would not be feasible to apply the efficient proximate cause doctrine because, given the combined nature of the damage, no efficient cause could be determined. Ultimately, the court applied the rationale from Wallach v. Rosenberg, 527 So. 2d 1386 (Fla. 3d DCA 1988) and held that “where weather conditions combine with human negligence to cause a loss, it seems logical and reasonable to find the loss covered by an all-risk policy even if one of the causes is excluded from coverage.” Sebo, 208 So.2d at 700, citing Wallach.

While the Sebo opinion may lead to the assumption that the efficient proximate cause doctrine is dead in Florida, some courts applying Sebo seemingly limit the holding to those situations where no efficient proximate cause can be determined. See e.g. Jones v. Federated Nat'l Ins. Co., No., 2018 WL 443892, (Fla. Dist. Ct. App. Jan. 17, 2018). Therefore, if the damage occurs in a manner that allows the determination of an efficient proximate cause because, given the combined nature of the damage, no efficient cause could be determined. Ultimately, the court applied the rationale from Wallach v. Rosenberg, 527 So. 2d 1386 (Fla. 3d DCA 1988) and held that “where weather conditions combine with human negligence to cause a loss, it seems logical and reasonable to find the loss covered by an all-risk policy even if one of the causes is excluded from coverage.” Sebo, 208 So.2d at 700, citing Wallach.

In Florida, this can potentially result in an insured being able to recover the full limits of its flood policy and its wind policy. In Citizens Prop. Ins. Corp. v. Hamilton, 43 So. 3d 746 (Fla. Dist. Ct. App. 2010), the court concluded that the trial court correctly barred evidence of the amount the insured received from its flood carrier in a trial to determine liability of the wind carrier for damages caused by wind. The court rejected the argument that the trial court should have applied the “total loss recovery” rule and limited the insured’s recovery to pre-loss value of the property.
The court reasoned that the two policies insured different perils and the premiums charged by the flood carrier calculated the risk posed by flood losses and the premium charged by the wind carrier took into consideration the exposure to total losses under Florida’s Valued Policy law. In Citizens Prop. Ins. Corp. v. Ashe, 50 So. 3d 645 (Fla. Dist. Ct. App. 2010), the court recognized that while Cox, supra, applied the Valued Policy Law only where a covered peril caused the total loss, it did not prevent the insured from arguing that wind caused the total loss even where the insured had already recovered from its flood insurer for a total loss. Id. at 651-652. The court rejected the insurer’s argument that the insured would be receiving a windfall, by noting that the flood policy contained a subrogation clause. Id. at 652. While the court seemed to insinuate the flood carrier could seek to recoup its payment under this provision, it is unclear whether courts would recognize a flood carrier’s right to recover a wind carrier’s payments through subrogation. The Ashe court also rejected arguments that the other insurance clause of the wind policy would apply because it would only apply if the other insurance covered the same perils. Id. at 650. Since the flood and wind policies covered different perils, that provision was not applicable. Id.

The District Court of Appeals in Sebo recognized that “Florida courts have not definitively weighed in on” whether ACC clauses are enforceable in Florida. Am. Home Assur. Co. v. Sebo, 141 So. 3d 195, 202 (Fla. Dist. Ct. App. 2013), review granted, decision quashed sub nom. Sebo v. Am. Home Assurance Co., 208 So. 3d 694 (Fla. 2016). That court found that the policy language at issue “was insufficient to exclude losses arising from concurrent causes.” Id. Both the appellate court and the Florida Supreme Court recognized that Sebo’s policy had some exclusions with specific ACC language, but the construction defects exclusion did not have the ACC language.

The Supreme Court found it significant that the insurer explicitly wrote sections of the policy to avoid applying the concurrent causation doctrine, and concluded that failure to include an anti-concurrent causation language in the construction defects exclusion expressed an intent to apply the concurrent causation doctrine with construction defect claims. Although not specifically reaching a conclusion on the application of anti-concurrent causation language, it would appear that had the construction defect exclusion included such language, the court might have reached a different conclusion. Therefore, it is important to review the policy exclusions that may be applicable to any loss and determine if they are subject to anti-concurrent causation language.

Causation is a critical issue in natural disaster-related insurance claims. An understanding of the policy language, the specific chain of events or circumstances leading to the loss, and the law in the relevant jurisdiction(s) is imperative to presenting the claim in the most favorable manner.

5. CIVIL AUTHORITY COVERAGE

Evacuation orders issued in relation to Natural Disasters can result in business interruption claims for businesses forced to shut down during the evacuation orders. Typically, the insureds will look to coverage for “civil authority” in making these claims. In order to trigger coverage, the act of civil authority must typically be a direct result of a covered cause of loss to property other than the insured property.

For example, many of the curfews and evacuations in wake of hurricanes can result from the threat to public safety caused by flooding. But many commercial property policies specifically exclude flooding. In these cases, there would be no coverage for loss of business during the forced closures.
See e.g. Bamundo, Zwal & Schermerhorn, LLP v. Sentinel Ins. Co., Ltd., No. 13-cv-6672, 2015 WL 1408873 (S.D.N.Y. Mar. 26, 2015) (holding that there was no coverage under a civil authority provision because the evacuation order was based on flooding, which was an expressly excluded cause of loss).

The act of civil authority must also typically result from property damage that has already occurred or is in the process of occurring – coverage will not be triggered if the civil authority was issued in anticipation of future damage. This requirement may be key to coverage because in many cases, the evacuations or curfews were put in place in anticipation of future harm that Harvey and Irma would bring.

Many policies further require that the civil authority order prohibit access to the insured property due to damage to property nearby or adjacent to the insured premises, a requirement that courts will enforce. Syufy Enterprises v. Home Insurance Co. of Indiana, No. 94-0756, 1995 WL 129229 (N.D. Cal. Mar. 21, 1995) (denying coverage because no property adjacent to Syufy’s premises sustained physical damage); Bros., Inc. v. Liberty Mut. Fire Ins. Co., 268 A.2d 611, 613 (D.C. App. 1970) (denying coverage because the regulations were not the direct result of damage or destruction of adjacent property); Adelman Laundry & Cleaners, Inc. v. Factory Ins. Ass’n, 207 N.W.2d 646 (Wis. 1983).

However, if the policy does not require nearby or adjacent property damage, the precautionary evacuations may be covered if based on property damage that occurred in the Caribbean. See South Texas Medical Clinics, P.A. v. CNA Financial Corp., No. H-06-4041, 2008 WL 450012, *9 (S.D.Tex. Feb. 15, 2008) (holding that there was no coverage because the judge had issued the evacuation order “due to” fear that the Hurricane would strike, based in part of the physical damage in Florida, but it was not issued “due to” the physical damage in Florida). However, this is not always the case. See Dickie Brennan & Co., Inc. v. Lexington Ins. Co., 636 F.3d 683, 686 (5th Cir. 2011) (Court rejected argument that prior hurricane damage in the Caribbean created nexus for coverage for evacuation order in New Orleans).

If there is coverage for civil authority, the coverage extends only as long as access to the property is completely prohibited. See e.g., Southern Hospitality, 393 F.3d at 1140; TMC Stores, 2005 WL 1331700, at *4 (recognizing that other jurisdictions only find civil authority coverage available when access is completely prohibited). Many policies may also have a waiting period expressed in hours, typically 48 or 72 hours, only after which coverage will begin.

6. IMPACT OF AREA-WIDE ECONOMIC CONDITIONS AFTER A CATASTROPHE ON BUSINESS INTERRUPTION COVERAGE

Under ordinary, non-catastrophic circumstances, the performance of a business prior to the catastrophe can be an accurate measurement for how that business would have performed if the damage had not occurred. But the same may not be true following a wide-impact catastrophe. For example, an influx of temporary workers could cause local economies to boom, and a shortage of available hotel rooms or apartments could cause hotel rates and rents to increase. On the other end of the spectrum, many businesses may experience a significant decrease in profits in a post-catastrophe market as temporary population shifts may result in long-lasting changes in supply and demand for commodities and services. Consequently, measuring a policyholder’s business interruption (or time element) loss is one of the most contentious issues arising from wide-impact catastrophic events.

Although policy provisions vary, as do the types of coverage available, common business interruption provisions generally include something along these lines:

In determining the amount of the Time Element loss as insured against by this policy, due consideration shall be given to experience of the business before the loss and the probable experience thereafter had no interruption of production or suspension of business operations occurred. Two prevailing lines of authority exist for measuring a policyholder’s business interruption loss following a wide-impact catastrophe: the “Economy Ignored” and the “Economy Considered” tests. The Economy Ignored test looks backward and measures the policyholder’s loss only against pre-catastrophe business levels and does not take into consideration the impact of actual post-catastrophe conditions on the economy, market or demand. In Finger Furniture Company, Inc. v. Commonwealth Insurance Company, 404 F.3d 312 (5th Cir. 2005), the insurer wanted to consider the insured’s increased sales after it reopened to offset losses during the period of restoration. However, the Fifth Circuit court, applying Texas law, found the policy language did not suggest the insurer could look prospectively to what occurred to determine if its insured incurred a business interruption loss during the period of restoration. Instead, the court found that the policy language required consideration of the business experience prior to the date of loss and the business’s probable experience had the loss not occurred. The court concluded that only historical sales figures need be examined to answer both of those questions. It found that nothing in the policy allowed the insurer to examine “actual” sales after the loss.

Similarly, in Catlin Syndicate v. Imperial Palace of Mississippi, Inc., 600 F.3d 511 (5th Cir. 2010), the Fifth Circuit concluded that the insured could not consider its post-loss sales when calculating its loss during the period of restoration. The insured wanted to take into account its increased sales post-loss to argue for an increased business interruption loss during the period of restoration.
Although the Fifth Circuit decided *Catlin Syndicate* under Mississippi law and *Finger Furniture* under Texas law, the court concluded that the analysis in *Finger Furniture* was applicable because Mississippi law and Texas law were not in conflict on this issue. It concluded, as the court in *Finger Furniture* did, that the business interruption language only allowed reference to historical sales figures in calculating the actual loss sustained by the insured and there was nothing in the business interruption language that would allow either party to take into account actual post-damage performance in determination of the loss.

The Economy Considered test, on the other hand, seeks to place the policyholder in the position that it would have occupied in the actual post-catastrophe environment had it been able to continue its operations. In *Berk-Cohen Assocs., L.L.C. v. Landmark Am. Ins. Co.*, 433 F. App'x 268, 270 (5th Cir. 2011) the policy excluded from the business interruption calculation favorable business conditions caused by the impact of the Covered Cause of Loss. *Id.* However, since the favorable conditions that existed after the loss arose from flood, which was not a covered loss, the court concluded that the favorable rental market after the loss could be considered. In *Rimkus Consulting Group Inc. v. Hartford Cas. Insurance Co.*, 552 F. Supp. 2d 637 (S.D. Tex. 2007) a Texas court came to a different conclusion than the 5th Circuit in *Finger Furniture* because the policy there contained an offset provision specifically allowing consideration of an increase in business from “other income channels.”

Neither test consistently benefits a policyholder or an insurer in every situation; the outcome instead relies on the unique facts in each particular circumstance. And this issue, first and foremost, depends on the language of the policy, which may — but typically does not — provide clear guidance on the proper measurement of business interruption losses. In addition, certain carriers recently introduced language to reduce their exposures to post-loss economic changes, and that language has yet to be tested in court.

7. **CALCULATING BUSINESS INTERRUPTION WAITING PERIODS**

Time element coverage waiting periods often are expressed in the form of a period of time, meaning coverage kicks in only after the policyholder’s business has been disrupted for a certain amount of time – often ranging anywhere from 48 hours or 30+ days. Waiting periods typically are calculated from the date of first damage to the insured property. But policies may be ambiguous as to the method of calculating the waiting period. For example, in connection with Superstorm Sandy an insurer argued that a 72-hour waiting period meant nine working days because the business was open only eight hours per day. This is surely contrary to the insured’s reasonable expectations given the common understanding that 72 hours means three full days. Longer waiting periods can dramatically decrease insurers’ coverage exposure when facing large-scale catastrophes, so we can expect that insurers will take aggressive positions in this regard.

8. **TIMELINESS OF THE CLAIM AND POTENTIAL ENSUING LAWSUIT**

In the aftermath of a catastrophe, businesses are dealing with a multitude of crises and often are not focused on insurance. This is understandable. But insurance policies sometimes contain time limitations within which policyholders must take certain steps to present and preserve a claim. In the property context, the policy may require notice “as soon as practicable” and may require a
sworn proof of loss within a short time after the event — for example, within 60 or 90 days. Insurers may agree to extend the deadline to submit a proof of loss, but you need to request it and get it in writing. Policyholders need to review their policies closely and stay on top of these obligations and deadlines in their policies so that they do not jeopardize coverage. The best practice is to comply as soon as reasonably possible or get an extension.

9. WIND VS. STORM SURGE

After a catastrophic weather event in coastal areas, insurers and insureds frequently litigate whether property damage was caused by wind, on the one hand, or storm surge, on the other. Such litigation arises because property policies often cover damage caused by wind, while excluding coverage for damage caused by flood.

Courts considering such claims tend to characterize the peril of wind and the peril of storm surge separately. Courts have noted that storm surge is “little more than a synonym for a ‘tidal wave’ or wind-driven flood” and have held that damage from storm surge falls squarely within the bounds of flood exclusions, even where the flood exclusions do not expressly include the term “storm surge,” See, e.g., Leonard v. Nationwide Mut. Ins. Co., 499 F.3d 419, 436–38 (5th Cir. 2007); Tuepker v. State Farm Fire & Cas. Co., 507 F.3d 346, 352–53 (5th Cir. 2007); Bilbe v. Belsom, 530 F.3d 314, 316 (5th Cir. 2008) (“We have repeatedly held that the term ‘flood’ includes storm surges.”). By contrast, property policies generally cover damage caused solely by wind (i.e., wind that doesn’t interact with water). See e.g., Leonard, 499 F.3d 419; Tuepker v. State Farm Fire & Cas. Co., 507 F.3d at 354.

Accordingly, in the aftermath of a hurricane, coverage will likely hinge on whether the property damage at issue resulted from wind alone (for example, a structure was blown over by wind) or whether the damage resulted from storm surge (i.e., flooding caused by wind). Parties to a property policy are wise to keep the distinction between wind and storm surge—and the impact of such distinction—in mind when considering coverage issues in the wake of a hurricane.

10. TORNADO VS. STORM WINDS

Although not frequently litigated, coverage for wind damage in the aftermath of a catastrophe may turn on whether the peril that caused the wind damage is characterized as a “tornado,” on the one hand, or as a “storm” or “hurricane,” on the other.

For example, in State Farm Florida Ins. Co. v. Moody, 180 So. 3d 1165 (Fla. Dist. Ct. App. 2015), the insureds sought coverage for additional living expenses under a policy that limited the availability of such coverage if the claim for such expenses arose out of a “hurricane,” which was defined as a storm declared to be a hurricane by the National Hurricane Center of the National Weather Service. The insureds, however, asserted that their damage was not caused by a hurricane; rather, it was caused by tornado or microburst that occurred during the storm and that there was coverage because the policy did not limit coverage for damage caused by tornados. Although there was evidence that tornados and hurricanes are separate weather events, the court determined that the insureds were not entitled to recover because the hurricane spawned the tornado that caused the damage and thus the policy limitation for damage cause by hurricanes applied.
In *Moody*, the court found that the tornado, while a distinct weather event, was part and parcel of the hurricane that spawned it and thus the policy limitations for hurricane losses applied. However, *Moody* illustrates that coverage may turn on how weather events are characterized. Parties to a property policy may benefit by carefully parsing the wording of any coverage grants or exclusions and considering whether the at-issue policy language turns on characterizing damage as resulting from one event or another.

11. **WILDFIRES**

In *Oregon Shakespeare Festival Association v. Great American Insurance Company*, No. 1:15-CV-01932-CL, 2016 WL 3267247, at *1 (D. Or. June 7, 2016), vacated by joint request of parties, No. 1:15-CV-01932-CL, 2017 WL 1034203 (D. Or. Mar. 6, 2017), the insured sought coverage for business income losses that it incurred after nearby wildfires caused smoke, ashes, and dust to infiltrate the theater, coating the seating, HVAC, lighting, and electronic systems with dust, ashes, and smoke. The plaintiff insured was forced to suspend operations and cancel performances for several days to perform cleaning, replace air filters, and allow the smoke in the theater to dissipate. The court found that the insured sustained “physical loss of or damage to property” when the wildfire smoke infiltrated the theater and rendered it unusable for its intended purpose, and concluded that the policy covered the insured’s business interruption losses. The case was later vacated by joint stipulated request of the parties, but it remains an excellent example of the type of wildfire damage that can trigger business interruption coverage.

In California, mudslides often occur after a wildfire has denuded the land of vegetation. A question being raised is are these mudslides caused by fire, rain or mudflow. To answer the question, a California court will likely apply an efficient proximate cause analysis. Under “efficient proximate cause” analysis when a loss is caused by a combination of a covered risk and a specifically excluded risk, the loss is covered only if the covered risk was the “efficient proximate cause” of the loss. *Garvey v. State Farm Fire & Cas. Co.*, 48 Cal. 3d 395, 770 P.2d 704 (1989). In California, efficient proximate cause means the “most important” or “predominant” cause. *Id.* It does not matter if an excluded peril, such as a mudflow, contributed to the loss as long as the covered peril, such as fire, was the predominant cause of the loss.

In the aftermath of the mudflows, California’s Insurance Commissioner issued a notice to insurance carriers advising them that mudflow exclusions are unenforceable if the “efficient proximate cause” of the mudslide was the wildfire. The California Senate also introduced a bill, SB 917, seeking to add a section to the Insurance Code regarding the efficient proximate cause doctrine and coverage for landslides.

*In Howell v. State Farm Fire & Casualty Co.* 218 Cal. App. 3d 1446 (1990), an insured submitted an insurance claim after heavy rains triggered a landslide that damaged its property. The insurer denied the claim based on the policy’s earth movement and water damage exclusions. At trial, the insured presented expert testimony that the landslide occurred as a result of a fire that destroyed vegetation on the slope where the landslide started. The California Court of Appeals held that where a covered peril, fire, was the efficient proximate cause of the mudslide, the policy’s earth movement exclusion was unenforceable, regardless of other contributing causes.