IMA Executive Risk Solutions

Quarterly Update – First Quarter 2022

Inside

Cases of Interest

+ Flurry of New Rules Issued by SEC on Cybersecurity, Climate and SPACs
+ Earnout Provisions Take Center Stage in Two Chancery Court Decisions
+ Securities Class Action Arising out of Cybersecurity Incident Survives Dismissal

D&O Filings, Pricing and Settlements

Cases of Interest

Flurry of New Rules Issued by SEC on Cybersecurity, Climate and SPACs

Cybersecurity

On March 9, 2022 the Securities and Exchange Commission issued a new rule aiming to enhance and standardize disclosures regarding cybersecurity risk management and incident reporting. In the words of the Commission, the rule is "designed to better inform investors about a registrant's risk management, strategy, and governance and to provide timely notification of material cybersecurity incidents."

Following previous guidance on this topic issued in 2011 and 2018, the new rule, which was adopted by a 3-1 vote, is intended to mandate more fulsome disclosure of a company's approach to cybersecurity. With respect to incident reporting, the new rule will require companies to disclose in an 8-K information about a material cybersecurity incident within four business days. It also requires updated disclosures on previously disclosed incidents, as well as when a series of undisclosed immaterial cybersecurity incidents become material in the aggregate. Lastly, it requires reporting companies to describe their cybersecurity policies and procedures, if any, management's role in implementing cybersecurity policies and procedures, and whether the board of directors possesses cybersecurity expertise.

While this rule may have been considered long overdue by some, its effect will likely remain open to debate for some time. From a practical standpoint, it makes sense to require a standardized timeframe within which reporting companies must disclose cybersecurity incidents to investors. However, what constitutes a 'material cybersecurity incident' for one company may not be true for another, thereby leaving the materiality determination within the purview of the board. Another question is whether – or, more likely, to what extent – the plaintiffs' bar will seek to rely on a company's disclosures as evidence of securities law violations. Given the liability and exposure companies face from cybersecurity, it will be interesting to see the level of detail such disclosures include.

Environmental

Only a few weeks later, the SEC then issued rule amendments requiring registrants to include certain climate-related information in registration statements and periodic reports. Under this proposal, companies will need to identify climate-related risks that are likely to have a material impact on their business, results of operations, or financial condition. It also mandates certain climate-related disclosures, such as greenhouse gas emissions, both direct and indirectly produced by way of the company's upstream and downstream activities in its value chain.

Cases of Interest

Flurry of New Rules Issued by SEC on Cybersecurity, Climate and SPACs (continued)

Environmental, *cont.*

Smaller reporting companies will be exempt from certain disclosure obligations, which are similar to those many companies are already providing based on the broadly accepted frameworks included in the Task Force on Climate-Related Financial Disclosures and the Greenhouse Gas Protocol. The rule includes a phase-in period for all registrants, with the compliance date dependent on filer status.

As a result of this rule, companies will be forced to specify their processes for identifying, assessing and managing climate-related risks, as well as whether such processes are integrated into the overall risk management system in place. It will further require registrants to detail if a transition plan has been adopted along with whether they use an internal carbon price and how that number was set. In addition, if a registrant has publicly set climate-related targets or goals, it requires disclosure of the scope of activities and emissions included in that target and the timeline for completion. Companies with such goals will need to provide relevant data indicating their relative progress each fiscal year and the extent to which any carbon offsets or renewable energy certificates are a part of the overall plan.

SPACs

The final area of SEC activity we believe warrants discussion deals with Special Purpose Acquisition Companies (SPACs).

On March 30, 2022, the SEC issued its proposed rule that, if implemented, will have far-ranging implications for the six hundred some SPACs currently seeking merger targets. It will require the disclosure of additional information regarding SPAC sponsors, conflicts of interest and dilution likely to result from consummation of de-SPAC transactions. The compensation and fees to be earned by the sponsor and SPAC directors will also now have to be disclosed. It further requires the disclosure of any fairness opinion generated in conjunction with the proposed business combination and deems the target company a co-registrant on Form S-4 or Form F-4 for the de-SPAC transaction, thereby extending Section 11 liability under the Securities Act of 1933 to the private operating company along with its directors and officers.

Generally speaking, the proposed rule seeks to ensure the same rules applicable to traditional IPOs are being followed by SPACs. In that regard, it explicitly addresses the question of whether and under what circumstances a SPAC could be considered an Investment Company under the Investment Company Act of 1940. Safe harbor protections available therein would only be available for SPACs that satisfy certain conditions limiting the duration, asset composition and business purpose/activities thereof. In addition, it removes safe harbor protections under the Private Securities Litigation Reform Act for projections disclosed as a part of the de-SPAC transaction.

Cases of Interest

Flurry of New Rules Issued by SEC on Cybersecurity, Climate and SPACs (continued)

SPACs, *cont.*

As we have detailed here before, SPACs have attracted significant attention from regulators and the plaintiffs' bar alike. The proposed rule attempts to level the playing field and remove perceived benefits of using a SPAC, as opposed to a traditional IPO, in accessing public markets.

The rule is also designed to highlight the benefits being received by the SPAC sponsor and whether the sponsor's interests are aligned with shareholders, both of which are the subject of numerous ongoing cases challenging the fairness and structure of de-SPAC transactions.

Earnout Provisions Take Center Stage in Two Chancery Court Decisions

With earnout provisions being a part of nearly a third of recent M&A transactions, it shouldn't be a surprise that some have become the subject of litigation. As may be obvious, heightened attention should be paid to these provisions because the payment of millions of dollars hangs in the balance. Delaware's Chancery Court was recently asked to adjudicate whether payment was due under two such provisions.

In the first, the merger agreement called for payment of $95 million up front and up to $225 million in potential earnout payments. The earnout would become due unless: (1) the drug in fact failed to commence Phase III trials <u>and</u> (2) the failure to commence the trials was as a result of a "Fundamental Circumstance," defined as "a circumstance in which material safety or efficacy concerns made it impracticable to produce and sell or obtain regulatory approval for a drug".

After the deal closed, the FDA ordered a temporary halt to further trials due to safety concerns. With the Phase III trials halted, sellers were notified that a Fundamental Circumstance had occurred and payment would not be made under the earnout clause. Litigation ensued and concluded with the Chancery Court finding the buyers were obligated to pay the earnout. The judge found that while the FDA's actions constituted a Fundamental Circumstance, the evidence revealed additional business reasons for which Phase III trials weren't pursued. The court ruled the "as a result of" wording contained in the definition of a Fundamental Circumstance meant it had to be the sole reason Phase III trials weren't commenced. As such, sellers were entitled to the earnout payments.

The second case focused on conduct of sellers after the merger closed. The terms of the deal called for $120 million paid up front and a potential earnout of up to $100 million. The earnout would become due if certain new and specific Medicaid and Medicare reimbursement codes were issued for drugs manufactured by the company.

Cases of Interest

Earnout Provisions Take Center Stage in Two Chancery Court Decisions (continued)

Fearing the codes wouldn't come to fruition, three former executives of the seller took matters into their own hands and expended significant effort to ensure the codes were issued to ensure payment of the earnouts. Despite the codes eventually being issued, the buyer refused to pay and the matter ended up in court. Buyers relied on two provisions they argued were breached by sellers. The first specified the "sole and exclusive right" of sellers would be receipt of earnout payments, and the other stated that buyers had the right to operate the business as they chose. The buyers argued that post-closing conduct of the executives interfered with operation of the business and violated the agreement. The Chancery Court rejected this position, finding that the earnout provisions did not bar sellers from acting to ensure issuance of the Medicaid/Medicare codes.

The court interpreted buyers' arguments as seeking to imply additional contractual obligations that were not a part of the agreement. As was the case above, the earnout payments were upheld.

Similar to the painstaking level of detail a professionally brokered D&O policy contains, purchase and sale agreements must be as precise as possible and any earnout clauses contained therein should be scrutinized to ensure they are not subject to varying interpretations. *Shareholder Rep. Services, LLC v. Shire US Holdings, Inc.* 2020 WL 6018738 (Del. Ch. October 12, 2020); *Pacira Biosciences, Inc. v. Fortis Advisors LLC* 2021 WL 4949179 (Del. Ch. October 25, 2021).

Cases of Interest

Securities Class Action Arising out of Cybersecurity Incident Survives Dismissal

Following disclosure of an intruder in its systems in December 2020, a provider of network and security products found itself the subject of a securities class action. In January 2021, shareholders filed suit against the company and its directors and officers alleging they had falsely and misleadingly told investors the company had a robust cybersecurity system in place and adhered to specific cybersecurity practices as were detailed on its website. Claimants allege the company's actual cybersecurity measures were woefully deficient and "not as represented". The amended complaint documents specific incidents where cybersecurity issues were presented to upper management and did not result in any action being taken to fix the problems. Allegations of the CEO selling over $20 million in company stock in addition to two private equity firms selling over $261 million in shares one week before the incident was disclosed publicly were also included in the complaint.

On March 30, 2022, a federal judge issued its ruling on the Motion to Dismiss. The order granted in part and denied in part the motion. The motion was denied as to the company and the VP for Security Architecture. The judge also refused to dismiss the control person claims under Section 20(a) against the CEO as well as the two private equity firms.

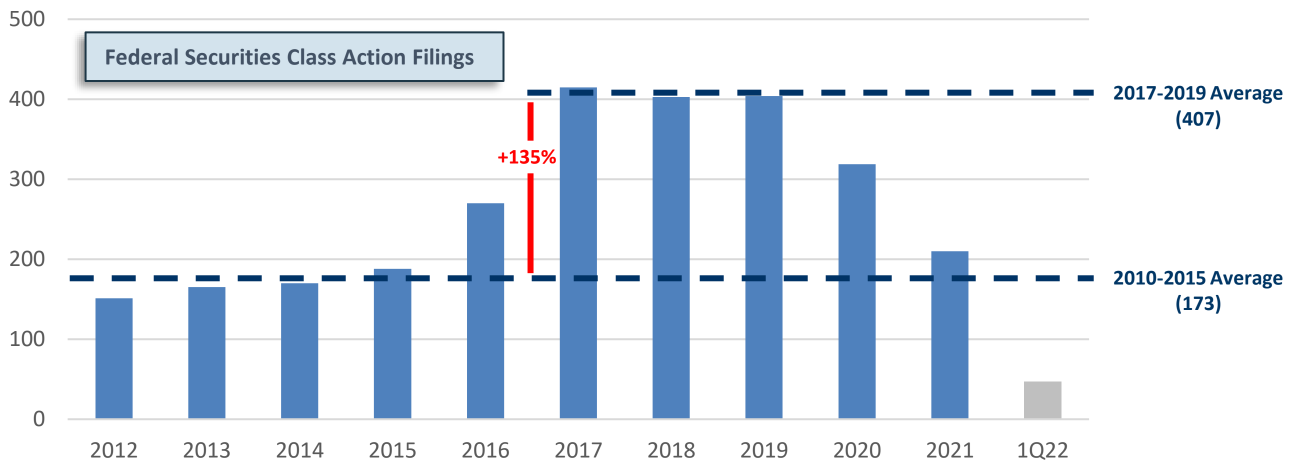
In doing so, the court held plaintiffs adequately alleged scienter with respect to the VP and company. On the other side of the coin, the 10(b) claim against the CEO was dismissed without prejudice, meaning claimants will likely get another attempt to make these allegations stick.

As we have seen with other "event driven" litigation, this case represents another example of a cybersecurity breach leading to litigation against directors and officers. Unlike numerous other examples, however, this case survived a Motion to Dismiss. The aspect of the ruling relating to the private equity firms is also noteworthy. It will likely be heavily scrutinized within the private equity industry given that the two firms involved both held only minority interests in the company. Whether any conclusions can be drawn from this case remains to be seen; however, it represents the rare instance in which a cybersecurity event and attendant D&O litigation survived a Motion to Dismiss. *In re SolarWinds Corp. Securities Litigation*, Case 1:21-cv-00138-RP (W.D. Tex. March 30, 2022).

D&O Filings, Pricing and Settlements

D&O Filings

- As we have previously reported, D&O Federal Securities Class Action Claims have decreased noticeably over the last two years.
    - This has been a welcome development, following a multi-year run of elevated claim filings.
    - The 2017-2019 average of 407 filings exceeded the 2010-2015 average of 173 filings by 135%.
- In 2021, there were 210 total Federal Securities Class Action Claims, which represents a 36% year-over-year decrease.
- In 1Q2022, filings continued at a lower rate (47 total). This implies an annualized number of 188 filings.



D&O Pricing

- With D&O litigation continuing its downward trend, dismissal rates remaining elevated, and new capacity entering the marketplace, D&O pricing adjustments for recent renewals have continued to be more favorable than year ago levels.
    - Companies considering an IPO or de-SPAC transaction can continue to expect elevated pricing and retentions, but both of these are also generally more favorable than 2021 levels.

D&O Settlements

- 87 Federal Class Action Securities Claim settlements were approved in 2021, versus 77 in 2020.
    - An increase in the number of settlements was expected, given the elevated filing levels that began in 2016 and a median time of 3+ years from filing to settlement.
- Average settlement size in 2021 was $20.5 million, while the *median* settlement size decreased 21% to $8.3 million.
- Dismissal rates have moved into the low-50s, meaning 50%+ of core federal filings are dismissed.

Sources: Cornerstone Research; Stanford Law School; IMA proprietary database

Key Contacts

Brian R. Bovasso
Managing Director
IMA Executive Risk Solutions
303.615.7449
brian.bovasso@imacorp.com

Travis T. Murtha
Director of ERS Claims
IMA Executive Risk Solutions
Legal & Claims Practice
303.615.7587
travis.murtha@imacorp.com

Daniel Posnick
Transactional Liability Leader
IMA Executive Risk Solutions
303.615.7747
daniel.posnick@imacorp.com

About IMA

IMA Financial Group is a privately held, diversified financial services firm focused on protecting client assets and creating exceptional value for our clients around the world. Our diverse team of experienced and talented professionals shares an unwavering commitment to excellence.

IMA Executive Risk Solutions is our world-class team of 20+ professionals focused on providing thoughtful advice, a unique legal perspective, a broad range of executive risk insurance solutions, and excellent service to our valued clients. Our professionals have deep experience handling complex executive risk exposures for a variety of clients – from pre-IPO start-ups to multi-billion dollar corporations.

© 2022 IMA Executive Risk Solutions. All rights reserved.

Protecting assets. Making a difference.

IMA Financial Group © 2022