Inigo 2022 D&O Defense Survey

The inside story on US Directors & Officers litigation

February 21st 2022

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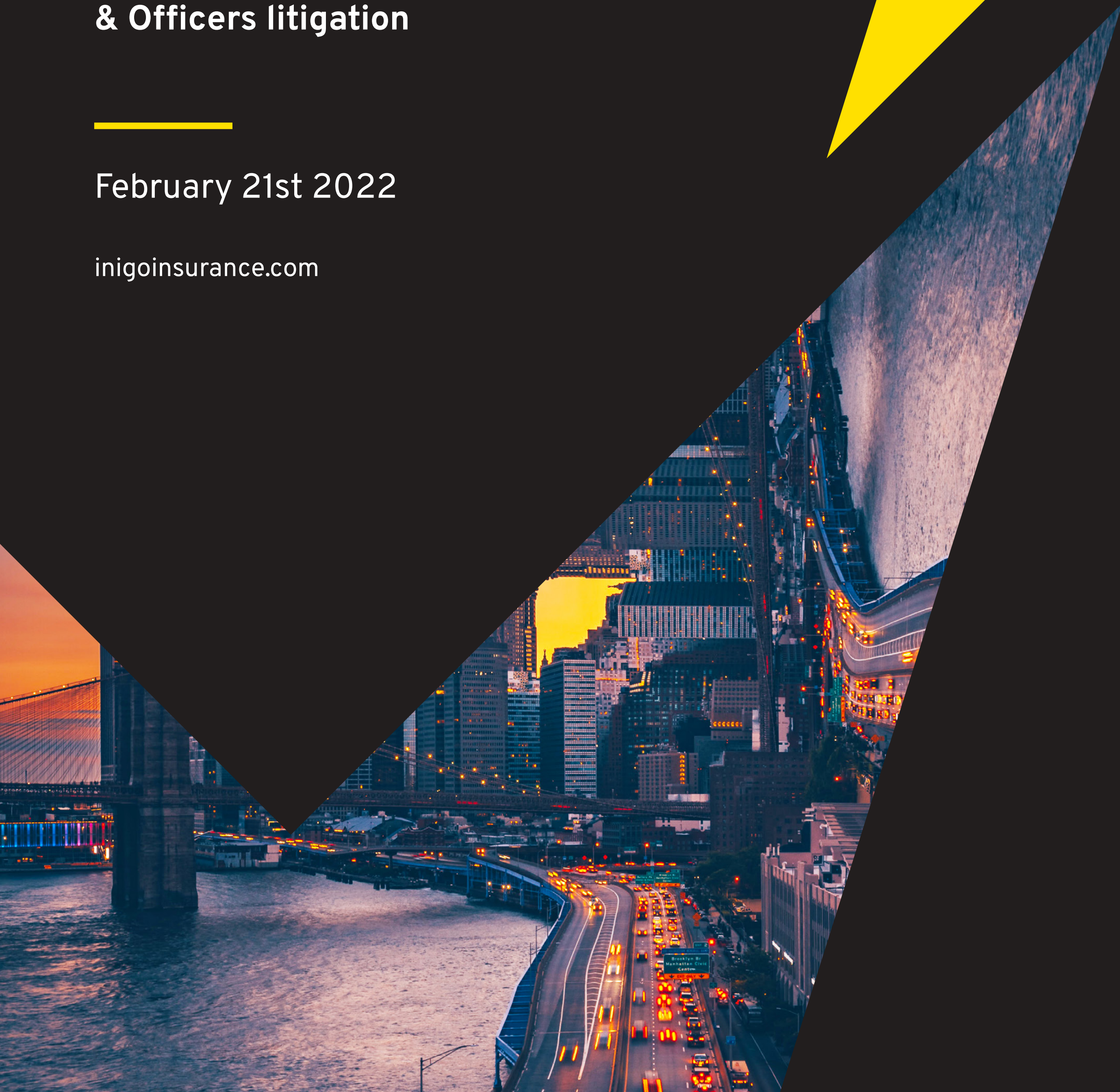

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Foreword

At Inigo, we want to do things differently.

As part of that, we want to better understand the key issues in D&O litigation to predict what may happen so that we can be ahead of the curve, rather than behind it. This is the catalyst for this report. We believe the best source of information on the current D&O landscape is the US securities defense bar, as they are the experts representing our clients. We compiled and presented a list of 45 questions on the D&O market. We chose 25 top law firms to answer them, based on their reputation among their peers, their securities litigation practice, and their track record in defending cases. We wanted to know, among other issues, about securities class action claim drivers and costs, derivative lawsuits, the regulatory environment, ESG and the US securities plaintiffs' bar.

While the range of opinions is diverse, key themes emerge which we share in this report to inform the discussion on key issues affecting our industry.

The D&O market has experienced significant change over the past three years. Inadequate rates and sharply rising claims drove rate increases as insurers sought to remediate their unprofitable books of business. While many exited the class altogether or cut back substantially, new entrants arrived – including Inigo. We want to take the market's temperature to understand what challenges we will face.

We intend to publish this survey annually. In our first survey, we identify four key themes we believe are the burning issues in today's D&O litigation landscape. We expect the themes to change every year, reflecting our view on what are the current hot topics in D&O litigation.

THIS YEAR'S THEMES ARE

01 US federal securities class actions – how many, how expensive to defend and are cases settling early?

02 Derivative litigation – what are the aggravating factors?

03 Environmental, social and governance (ESG) – will it be a game changer?

04 Biden's regulatory environment – is the watchdog's bite starting to match its bark?

We also wanted to make some predictions, based on the survey findings, which we will revisit next year to score our accuracy. Finally, we asked defense firms to tell us which plaintiff's firm they most respect. We rank the top five at the end of this report.

We hope you enjoy reading the report and would welcome any questions or feedback. If we missed what you think is a key topic, please let us know. Thank you.

Ed Whitworth
Head of Directors & Officers Liability

INIGO

Key Survey Findings

01 US federal securities class actions will return to pre-pandemic levels.

The strong consensus among our respondents is the number of securities class actions filed over the next 12 months will return to the high levels of 2019.

02 The derivative action claims environment continues to deteriorate with even larger settlements.

Respondents predict a gloomy outlook on the derivative front where they expect claims to rise.

03 Section 220 books and records demands are mushrooming.

They are a growing nuisance for public companies, as plaintiffs' firms increasingly file these alongside SCA and derivative litigation.

04 ESG is unlikely to result in securities litigation any time soon

ESG disclosures will not trigger a large increase in the next several years, despite the amount of public attention they receive.

05 Regulators are becoming more aggressive.

Although opinion is divided over whether the Securities Exchange Commission (SEC) will follow through in its drive for admissions of guilt in investigations.

06 SPACs and DeSPACs will drive more claims and coverage disputes.

These transactions will increasingly attract the attention of the plaintiff's bar and will also drive contentious coverage litigation.

01

US federal securities class actions

How many, how expensive to defend and are cases settling early?

As US federal securities class actions (SCAs) remain the greatest financial exposure for litigation against public companies and their directors and officers, we asked our respondents:

1. What driving factors significantly contribute to an increase of defense costs?
   a. prior to a Motion to Dismiss (MTD) ruling and
   b. after a case survives the MTD
2. Whether the presiding judge or the quality of the brief has greater influence on an MTD ruling?
3. What factors contribute to early SCA settlement?
4. What factors affect SCA frequency?

What drives defense costs prior to a Motion to Dismiss ruling?

At Inigo, we analyze SCA defense costs as they can erode a company's self-insured retention prior to an MTD ruling, creating insurance exposure. Therefore, we want to understand how much companies spend before an MTD ruling. Two thirds (69%) of our respondents consider $250,000 - $750,000 to be the average prior to the MTD ruling.

The survey ranks the following factors as contributors to higher defense costs prior to an MTD ruling:

1. the nature of underlying allegations
2. a concurrent regulatory investigation
3. the number of defendants

One respondent pointed to regional differences, noting that California, may be on the higher range as dismissals in that state's courts are ***"without prejudice"*** more often than in other jurisdictions, allowing plaintiffs to amend their complaint. Other factors such as insider trading allegations, the length of the complaint, the number of alleged false or misleading statements and the number of confidential witnesses also contribute to higher defense costs, according to survey respondents.

What drives defense costs after a case survives the Motion to Dismiss?

Our survey found a variety of reasons for increased defense costs after an MTD is denied. A fifth (20%) identify the law firms handling the matter on both sides as being the most significant factor. One respondent states: ***"Some firms do a much better job at controlling costs than others."*** Another supports this view, ***"Some plaintiff's firms can make cases more expensive, simply because they are better, work harder, and create more challenges for the other side."*** Other respondents highlight significant factors such as the complexity of class certification, the sheer number of the witnesses and documents, whether plaintiffs amend their complaint and the nature of the allegations.

Overall, respondents highlighted that the defense firm itself has a very significant influence on the cost of defending a case. One respondent says: ***"The reality is that some defense firms charge a lot more, for whatever reason. And some firms charge much more if the matter involves bigger dollars."*** Another respondent agrees: ***"Some firms do a much better job at controlling costs than others."***

Which has the greater influence on an MTD ruling: the presiding judge or the quality of the brief?

Just over half (56%) of respondents choose the quality of the brief, while the remainder (44%) believe the presiding judge has greater influence. Most comments explain why a judge is the principal factor, with one respondent saying: ***"I would love to take credit for my successes. But the judge is more important than the defense firm...the ability to influence a judge's decision has its limits in many cases. In close cases, of course quality briefing and arguments are key. But in many cases, the lawyering is secondary…"*** Another states: ***"Sometimes you get judges who simply are not gatekeepers and then, no matter how good the brief or argument, the motion is denied."***

What factors contribute to early SCA settlement?

Three quarters (74%) state that less than 10% of their cases settle prior to the MTD ruling, while the majority of remaining respondents indicate 10-20% of their cases do. This suggests the rate of SCA settlement prior to the MTD is typically in the 0-20% range, which remains low. When discussing the reasons for these early settlements, one respondent states: ***"I almost always explore settlement early. It is an opportunity to gather information. It usually doesn't work, of course. But I don't believe it is a sign of weakness."*** The consensus amongst respondents was that those SCAs that are settled early are usually either extremely weak or extremely strong. An additional factor cited by respondents is multiple rounds of MTD rulings, where a settlement can bring a less painful resolution.

Why are Section 220 books and records demands rising?

We also wanted to understand the increase in Section 220 demands being filed, and their role in helping to push up defense costs and impact settlements. In addressing our concern for increased defense costs for an increasing number of Section 220 Books and Records Demands, Smaller plaintiffs' firms are using 220 Demands to obtain nominal fees in larger cases, according to our survey. One respondent states: ***"220 Demands have gotten to be routine. More and more plaintiff's firms get involved. Five years ago, I rarely dealt with more than one plaintiff's firm on a derivative matter. Now we see a half dozen derivative cases for one matter all the time. It has become a feeding frenzy."***

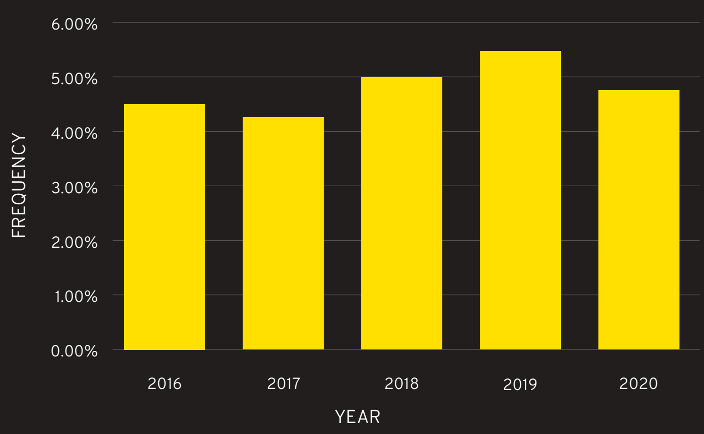
> Section 220 of the Delaware General Corporation Law allows stockholders to access corporate records for a ***"proper purpose"*** - most commonly to ***"investigate wrongdoing"*** such as a possible breach of fiduciary duty by the board or management.

Respondents highlight this as a trend to be wary of, as these additional demands make settlements more expensive without adding any real value to shareholders. The insurance industry should focus on finding a way to challenge these in a cost-effective manner.

What driving factors affect SCA frequency?

Finally, we wanted to determine whether the decrease in SCAs during the pandemic from a historical high was the new normal, as well as to find out what are the factors currently affecting the number of SCAs. Three quarters (74%) of respondents expect the number of SCA filings will increase in 2022. The reasons given by our respondents for the recent drop in filings include the lack of stock market volatility from April 2020 onwards, as well as plaintiffs' law firms focusing on larger cases which they believed they were more likely to win. With recent stock market volatility, public companies may see an increase in SCA claims if the US stock market enters correction territory, falling by 10% or more from its 52-week high.

SCA FREQUENCY (EXCLUDING M&A SUITS) **FOR LAST FIVE YEARS**



Will SPACs and DeSPACs be a new source of SCAs?

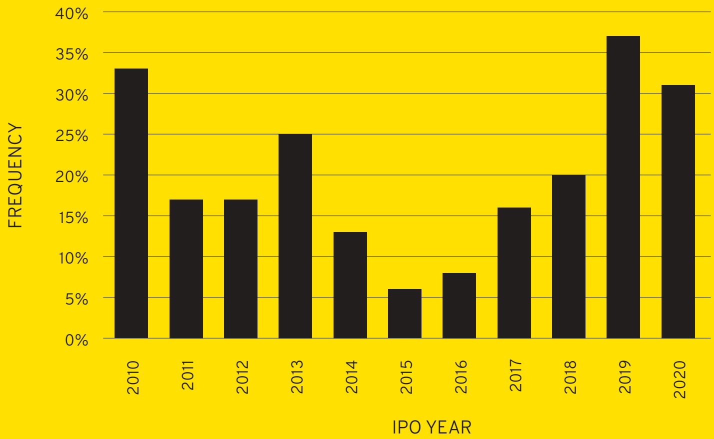
Special Purpose Acquisition Companies (SPACs) and the subsequent combined company, DeSPACs, are the centre of attention – not surprisingly given they accounted for more than half the total US initial public offerings in 2020. There has already been a spike in SCA filings against DeSPACs.

SPACs offer an alternative to traditional IPOs, in which a shell company goes public with the sole objective of merging with a private company to take it public. SPACs typically have two years to identify a target company to acquire or they must return the funds to shareholders.

Transactions are usually financed from a combination of the proceeds of the SPAC IPO and an additional funding round called a Private Investment in Public Equity (PIPE) offering. The remainder of the target company's value is held by the existing shareholders.

A DeSPAC transaction is attractive to private companies as it can be more straightforward than going public through an IPO, with a lower regulatory burden. Also, the valuation is set at the time the acquisition is announced, reducing uncertainty.

FREQUENCY OF CLAIMS AGAINST AGAINST DESPAC COMPANIES OVER TIME (BY YEAR OF TRANSACTION)



One third (30%) of respondents believe SPACs and DeSPACs will be responsible for an increase of SCAs in 2022. One respondent says: ***"…expect a tsunami of filings against SPACs and DeSPACs in the coming years".*** Another has the view that many of these companies are unprepared to go public: ***"The revenue forecasts they make in the investor decks are too optimistic and it is inevitable they will be revised, creating a simple case for a plaintiff."***

CONCLUSION

Clearly, the identity of the defense firm has a huge bearing on the costs and outcome of a case. The survey suggests it has a greater impact than the insurance market realizes.

We also shouldn't bank on the current trend of lower filings continuing. Most of our respondents feel this hiatus is temporary. We expect SPACs and DeSPACs will be a big driver in the number of new cases filed over the next 12 months, along with greater stock market volatility and the pressures created by higher inflation and continued supply chain disruption.

INIGO'S PREDICTION NO. 1

SCA filings will return to 2019 levels over the course of 2022 and 2023.

02

Derivative litigation

What are the aggravating factors?

To better understand derivative action frequency and severity, especially given recent large settlements, we asked respondents whether they believe the frequency of derivative actions has increased over the past five years. Three quarters (76%) of respondents believe it has increased.

What factors are driving an increase in derivative litigation?

There is no consensus among our respondents for what are the factors driving increased derivative litigation. Regulatory investigations and the level of a social controversy, loosely defined as the amount of adverse reaction generated by a company's business model or actions, tied for first place at 26%.

The next most common factor is a large fine or penalty at 15%. This lack of consensus suggests that derivative trends are relatively hard to predict, even for experts. When asked about the derivative action landscape over the past five years, a third believe it has become more difficult; a third believe it has stayed the same, while the remaining third say the landscape has improved.

What impact is Delaware having?

There is a greater consensus over what respondents think is changing the environment. Delaware case law is frequently mentioned in the responses. One respondent states: ***"Delaware has allowed more cases to get past a motion to dismiss in recent years. Caremark claims have reappeared and are much more common than they were just a few years ago. The road to dismissal has gotten harder. And the value of stand-alone derivative cases has increased."*** Another observes: ***"some areas have improved (like Delaware case law confirming that dilution leads to derivative rather than direct claims); and others have deteriorated (like Caremark claims becoming easier to get past motion to dismiss)."***

Caremark International in Derivative Litigation 698 A.2d 959 (Del. Ch. 1996) is a landmark case which set the standard for a company board's duty of oversight. Caremark shareholders brought a case alleging the directors breached their duty of care by failing to put in place adequate internal control systems, resulting in employees engaging in criminal conduct, which led to over $250 million in civil fines and penalties.

The case established the conditions for director oversight liability in derivative cases. It set a high bar, requiring plaintiffs to establish that directors breached their duty of care by failing to put in place adequate control systems.

It set an important precedent that it is not enough that wrongdoing happened on the board's watch. If there has been an allegation of wrongdoing in a company, the plaintiff needs to prove that:

1. **the directors knew or**
2. **should have known that violations of law were occurring and, in either event,**
3. **the directors took no steps in good faith to prevent or remedy that situation and**
4. **such failure resulted in the losses alleged in the complaint.**

As a result, it has been difficult to successfully bring derivative cases involving conduct by employees that led to a loss for the company.

Overall, the view of respondents was that cases are becoming more challenging to defend in Delaware as the Caremark standard is eroded.

What factors drive standalone derivative actions settlement values?

When assessing the factors which drive standalone derivative action settlement values, respondents highlight the same major factors as the reasons for filing: a large fine or penalty (35%) and the level of social controversy associated with the underlying allegations (22%). Interestingly, in third place is the conduct of the board of directors or executives (12%). A respondent states: ***"In some cases, such as cyber breaches, we stand a good chance if we can show that the board documented oversight of these areas in detail, and did everything [it] could to address issues when they were raised."***

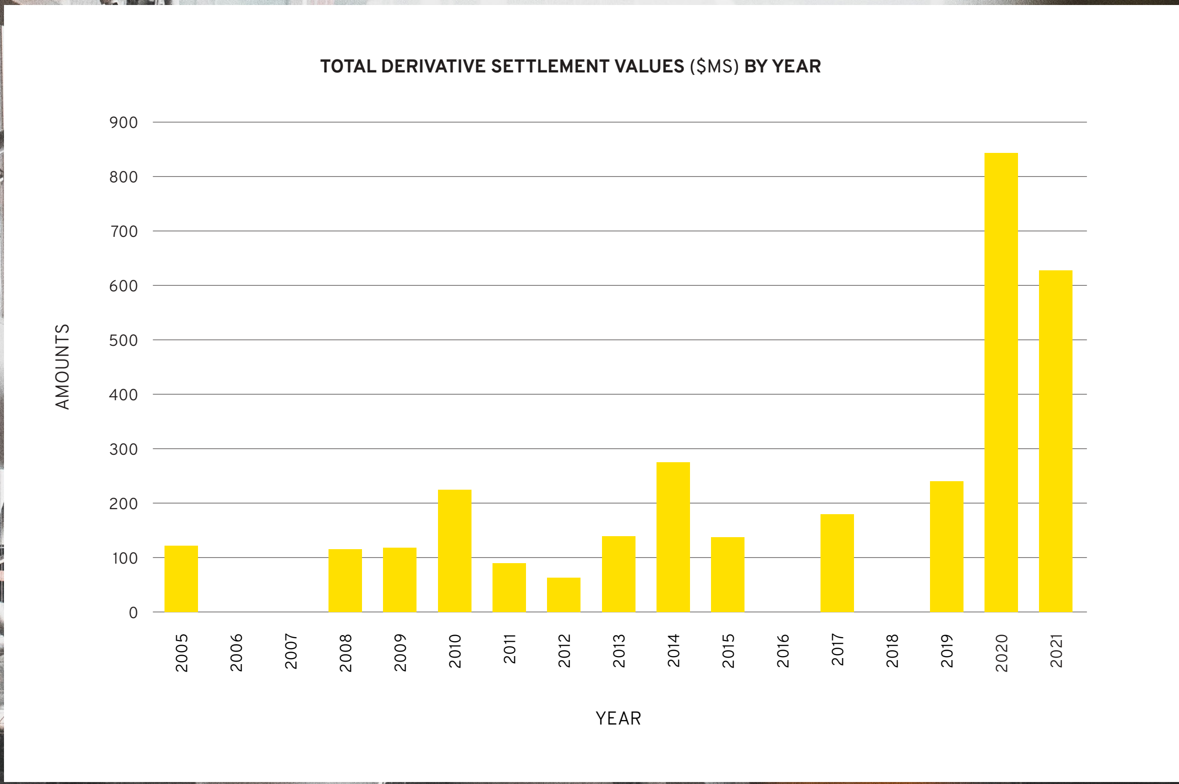
This points to there being scope to improve the outcome in a derivative action if the board can be found to have acted appropriately in respect of the underlying allegations and might suggest that insurers should look closely at how seriously the board takes hot button issues, for example, cyber readiness or sexual harassment allegations. How the board documents evidence of what actions it takes to manage such issues could make a material difference in defending a case.

How valuable is a Special Litigation Committee?

WHAT IS A SPECIAL LITIGATION COMMITTEE?

A committee of independent corporate directors assigned to investigate the merits of a shareholder derivative suit and, if appropriate, to recommend maintaining or dismissing the suit.

Respondents are critical of the use of Special Litigation Committees (SLCs) in derivative cases. One says: ***"The SLC process itself has become so convoluted and complicated, it's not really more efficient than just defending the case."*** Another respondent states: ***"SLCs are more prevalent because more cases have survived. They are expensive and not always effective."***
But not all respondents agreed. One argues: ***"Defendants should use empowered SLCs more often."*** Respondents suggest public companies should look more carefully at whether Special Litigation Committees are an effective strategy in derivative cases, or whether they are simply an expensive waste of time.



CONCLUSION

The survey shows a slightly deteriorating picture in respect of derivative cases. The erosion of the Caremark decision concerned several respondents, while the complexity of multiple suits and defending in multiple jurisdictions also worry respondents.

The findings suggest insurers should look more carefully at whether Special Litigation Committees are an effective strategy in derivative cases, or whether they are simply an expensive waste of time.

It is difficult to predict where derivative suits are going to come from, although the survey suggests there are some areas we can focus on, such as assessing in more detail a company board's oversight of key issues affecting their business. But we believe it will always be more challenging to accurately price derivative risk than SCA risk.

INIGO'S PREDICTION NO. 2

In 2022 we will see over $1bn in Derivative settlements and a higher number of actions filed than the average of five to ten each year.

03

Environmental, social and governance (ESG)

Will it be a game changer?

ESG is a topic that is dominating the press now, with many articles predicting ESG litigation will skyrocket. Insurers are trying to assess their likely ESG exposure, so we are eager to find out what the leading US defense attorneys think on this matter.

We asked respondents how important they thought ESG is going to be in driving claims frequency in the next few years. 80% indicate that ESG claims in the D&O litigation arena will be insignificant (answering either 'somewhat important,' 'neither important or unimportant,' or 'somewhat unimportant') while 20% believe they will be important. Most respondents believe ESG litigation is more likely to involve plaintiffs' firms effectively re-branding other facts as ESG issues rather than filing new types of claims – importantly, facts which would still have led to claims in the past. One respondent states: ***"ESG is a very important area, but most of the actions and investigations will involve underlying conduct that would have led to these actions and investigations regardless of the label."***

Other respondents point out that plaintiff's firms have not yet had much success with ESG cases. ***"ESG issues have been the driving force behind a number of recent cases. But many of them have died a quick death so far,"*** stated one, while also adding a note of caution:, ***"I think that will change as plaintiff's firms figure out how to plead around the impediments that have been identified so far. Plaintiff's firms are creative and not easily deterred."***

Plaintiff's attorneys are likely to require imagination and resourcefulness to bring meaningful, actionable ESG complaints that survive a motion to dismiss. As we have seen in some of the recent litigation on board diversity and cyber breaches, judges are making plaintiff's lawyers meet a high barrier to bring successful ESG complaints.

INIGO'S PREDICTION NO. 3

ESG claims will not become a significant new area of litigation in the next 36 months. It is more likely that ESG claims will be included as part of broader allegations.

04

Regulatory environment

Is the watchdog's bite starting to match its bark?

While SCAs and derivative actions often dominate a D&O discussion, we are concerned about the Securities Exchange Commission's (SEC's) recent moves which signal more aggressive enforcement under the Biden administration.

Which factor is more likely to prompt a regulator to launch an investigation?

Monitoring the number of investigations being filed is an important factor in how we price risk, yet there is little publicly available data, which adds to the challenge. Given the apparent changes in the regulatory environment due to the change in administration, we asked respondents to rank the most likely cause of a regulatory investigation. Half of the respondents (54%) attribute accounting/financial restatements as the most likely factor for a regulator to launch an investigation, while a quarter (27%) believe whistle-blower actions are the largest driver. Data breaches are ranked in third place (13%).

Which area of litigation currently poses the most financial and reputational risk to public companies?

Three quarters (78%) of respondents believe regulatory investigations are the area of litigation that present the biggest threat to their clients. One respondent says: ***"In most industries, key decision makers understand that private litigation happens and does not, in itself, denote wrongdoing. Where regulators publicly take a position adverse to an individual or company, though, reputational harm is much harder to downplay."***

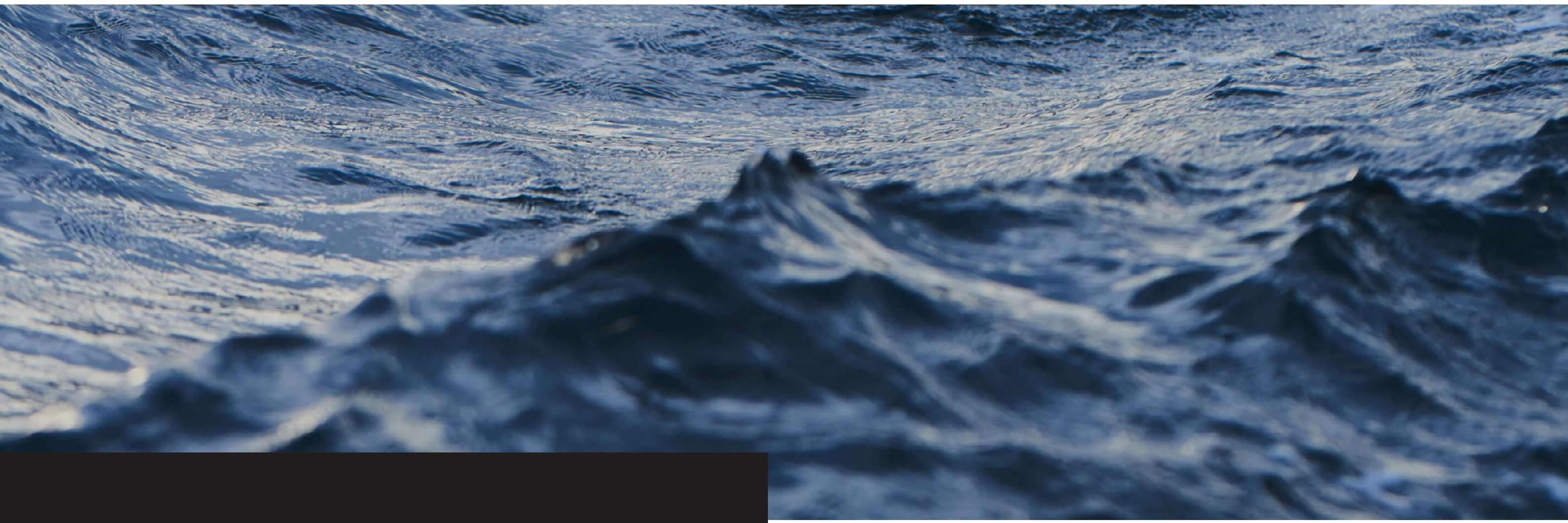
When settlements of government investigations become public, they are ***"perceived as more serious, whereas private securities litigation and derivative litigation is more opportunistic,"*** said one. Where a regulatory investigation or settlement becomes public, it will almost inevitably trigger private plaintiff's firms to file securities or shareholder derivative litigation against that company, our respondents state. One notes: ***"Regulatory investigations tend to have more credibility in the eyes of the public than private shareholder actions."***

What impact will the Biden administration have on the regulatory pursuit of public companies?

Gary Gensler's appointment as SEC Chairman by President Biden has signalled a change in approach from the regulator as he promises more aggressive enforcement. As part of this, a new tougher stance has been signalled by Gurbir Grewal, the Director of the SEC's Division of Enforcement, who intends to push for more admissions of responsibility in cases. He has stated: ***"When it comes to accountability, few things rival the magnitude of wrongdoers admitting that they broke the law, and so, in an era of diminished trust, we will, in appropriate circumstances, be requiring admissions in cases where heightened accountability and acceptance of responsibility are in the public interest."***

Two thirds (69%) of respondents believe the number of investigations launched has increased under the new administration; however, respondents are split down the middle over whether this new approach will have a significant impact.

Those who believe there is unlikely to be much change under the new regime expect the SEC will revert to its previous approach of settlements with no admission of guilt. According to one respondent: ***"The SEC usually caves on this issue during settlement."*** The views of the other half of respondents are summed up by one who comments: ***"it clearly will create problems that will cross over to private civil litigation, as admissions of liability/wrongdoing/culpability will create collateral effects that will be difficult to manage...it will make it more difficult to resolve matters without litigation."***



INIGO'S PREDICTION NO. 4

Regulatory investigations are going to be more expensive to defend as the SEC become more aggressive and demand admissions of wrongdoing which could set a new benchmark beyond the Biden administration.

CONCLUSION

If the SEC does follow through on its tougher language, then it would pose challenging questions for the insurance market. Fines and penalties are not insurable, so we could see cases litigated more aggressively to avoid admissions of guilt, or disputes may arise around the insurability of cases that do settle with an admission of wrongdoing. This makes our fourth prediction the most difficult. We have come down on the side of respondents who believe the SEC is going to follow through on its public statements of intent.

Inigo's 2022 D&O Predictions

01

SCA filings will return to 2019 levels over the course of 2022 and 2023.

02

We will see over $1bn of Derivative settlements in 2022 and more new claims filed than the historical average.

03

ESG claims will not grow to form a significant new area of litigation over the next 36 months. Rather, it is likely that ESG claims will be included as part of broader allegations.

04

Regulatory investigations are going to be more expensive to defend as the SEC become more aggressive and demand admissions of wrongdoing could set a benchmark beyond President Biden's term of office.

We will mark these predictions in the 2023 report.

Which are the best US securities plaintiffs' law firms?

We asked our respondents to name which plaintiff's firm they most respect. They are likely to be in the best position to assess who are their most formidable adversaries, based on their effectiveness as shareholder advocates, as litigators and in case outcomes.

According to our survey they are:

01	**Bernstein Litowitz Berger & Grossman LLP**
02	**Robbins Geller Rudman & Dowd**
03	**Labaton Sucharov LLP**
04	**Pomerantz LLP**
05	**Grant & Eisenhofer**

Bernstein Litowitz Berger & Grossman LLP ranks first, with 50% of the vote. One respondent describes their lawyers as a ***"formidable advocate for shareholders."*** Robbins Geller Rudman & Dowd comes in second, with 30%. The remaining three law firms in our survey make up another 15% of the vote. This suggests that these two firms are head and shoulders above their peers, in the opinion of our survey respondents.
We await news of whether they maintain their dominance in our 2023 survey.

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