January 2020

2019 Quarterly Review – Fourth Quarter

News and Developments in Executive Liability and Insurance

In this Issue

From the Editors

Welcome to the Quarterly Review for the Fourth Quarter 2019. There were a number of developments in the courts that affected the corporate governance and management liability space. We address the important interpretation of the *Caremark* standard, which is used to demonstrate a breach of the duty of loyalty by a director. We also see how the *Cyan* decision last year has continued repercussions for corporations both in terms of securities litigation, and in terms of a renewed push for forum selection clauses. This quarter we review a number of decisions regarding policy exclusions, including the conduct exclusion and the contract exclusion. We address an interesting case regarding standing and several dismissals of securities litigation. Our Cyber Corner discusses the potential for federal privacy regulations in 2020.

We hope you enjoy this issue of the Quarterly Review. As always, the FSG Legal & Claims team is available to discuss these issues with you.

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General News

A Second Delaware Case Finds Potential *Caremark* Liability

Prior to 2019, potential liability under the Caremark standard in Delaware derivative litigation was rare, as it was viewed as one of the most difficult theories of corporate liability on which to prevail. To establish liability, moving plaintiffs are required to plead and prove that directors acted in bad faith such that it can be proven that directors knew that they were breaching the duty of loyalty, as set forth in *In re Caremark Int'l Inc. Deriv. Litig.,* 1996 Del. Ch. LEXIS 125 (Del. Ch. 1996). Stated differently, boards are presumed to have acted in good faith and in their companies' best interests. Compelling evidence of more than mere negligence or poor governance, including evidence of board members' failure to act or actual knowledge of their fiduciary breach, is required to overcome that presumption.

The Chancery Court held that the plaintiffs had sufficiently alleged facts regarding the defendants' failure to conduct adequate oversight of food safety, which was a critical issue

In a trend developing this year, the Delaware Supreme Court has found liability established under the *Caremark* standard. In June, the court reversed a Delaware Court of Chancery dismissal of a *Caremark* claim involving Blue Bell Creameries. The Chancery Court held that the plaintiffs had sufficiently alleged facts regarding the defendants' failure to conduct adequate oversight of food safety, which was a critical issue given the nature of Blue Bell Creameries' ice cream product. *Marchand v. Barnhill,* 2019 Del. LEXIS 310 (Del. 2019).

On October 1, the Chancery Court weighed in on another *Caremark* case, denying a motion to dismiss in *In re Clovis Oncology, Inc. Derivative Litigation.* Citing the June 2019 *Marchand* decision, the court highlighted the importance of board oversight of compliance with legal and regulatory requirements, particularly for companies that have a single product on offer. Here, the pharmaceutical company had no sales revenue and was relying on the future success of its only promising drug, a cancer treatment. The board had received conflicting reports about its success but the company consistently reported positive and unverified results. After the Federal Drug Administration identified discrepancies in the drug trial results, the company reported them, resulting in a share price drop, securities litigation, and regulatory penalties. The court concluded that the board, composed of doctors and other knowledgeable professionals, failed to exercise meaningful oversight, such as in refusing to investigate conflicting trial results. *In re Clovis Oncology, Inc. Derivative Litig.,* 2019 Del. Ch. LEXIS 1293 (Del. Ch. 2019).

Cyan Continues to Wreak Havoc: Compels Remand of Previously Removed State Court Securities Suits

The procedural havoc that *Cyan, Inc. v. Beaver Cty. Emples. Ret. Fund,* 138 S. Ct. 1061 (2018) caused continues to be on display.

In November 2015, two investors of redeemable preferred stock (of Miller Energy Company ("Miller") which subsequently filed for bankruptcy after the stock offering) filed separate actions under the Securities Act of 1933 in Tennessee state court against Miller's directors and officers, as well as the underwriters of the stock offering. Shortly after the filing of the two complaints, the defendants removed the actions to federal court. The plaintiffs responded procedurally by filing motions to remand the actions back to state court. The federal court denied the motions to remand and also granted the defendants' motion to consolidate the two actions, together with a third action that had been filed in federal court in the first instance.

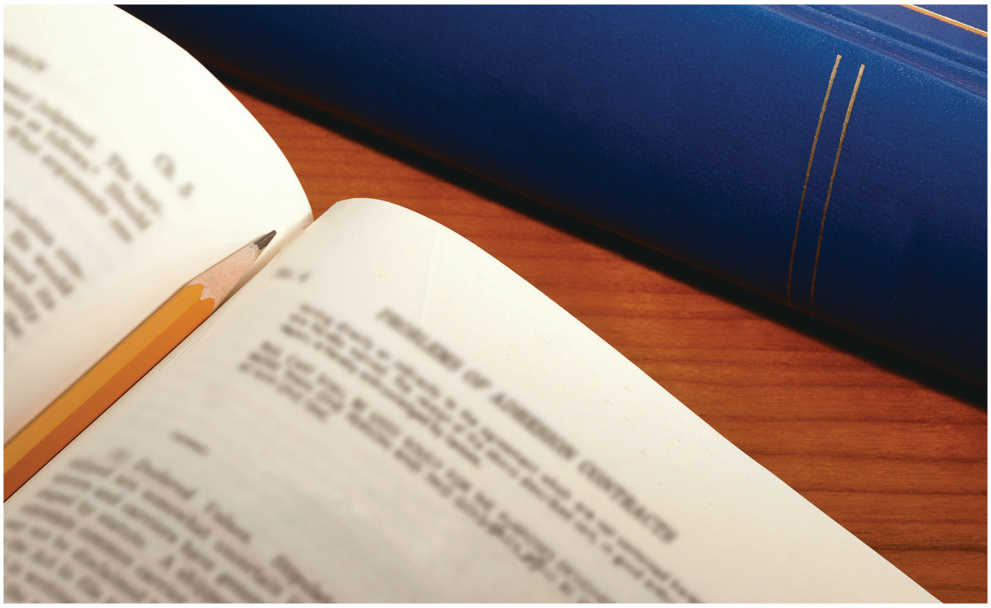
After the three actions were consolidated and federal court found to be the proper venue, the plaintiffs filed an amended consolidated complaint.

The defendants responded by filing a motion to dismiss, which was granted in part and denied in part. In June 2018, following the March 2018 decision in *Cyan*, the plaintiffs filed a renewed motion to remand the cases to state court.

On December 6, 2019, Judge Varlan granted the plaintiffs' motion to remand to state court, the two originally filed state court actions (but declined to remove the third action, which was originally filed in federal court). The court reasoned that the United States Supreme Court's *Cyan* decision, entered subsequent to its prior ruling which had previously denied the plaintiffs' motion to remand, represented the kind of "extraordinary circumstances justifying reconsideration of the Court's prior holding, namely a 'subsequent contrary view of the law by the controlling authority.'" The court also ruled that the plaintiffs, by engaging in limited litigation activity in the consolidated federal court action, had not waived their right to object to improper removal.

> The court reasoned that the United States Supreme Court's *Cyan* decision, entered subsequent to its prior ruling which had previously denied the plaintiffs' motion to remand, represented the kind of "extraordinary circumstances justifying reconsideration of the Court's prior holding..."

This decision underscores the procedural complexity *Cyan* has caused. Here, from a situation in which three pending actions were consolidated for procedural purposes into a single proceeding, Miller's directors and officers, as well as underwriters, must now defend two actions in state court and one in federal court. *Gaynor, et al. v. Miller, et al.,* USDC EDTN 3:15-cv-545 (USDC EDTN, December 6, 2019).



Supreme Court to Consider Challenge to SEC's Power to Obtain Disgorgement

The United States Supreme Court has agreed to review a case that could decide whether the Securities and Exchange Commission (SEC) has the authority to demand and obtain disgorgement as a form of relief for a securities law violation. This has become a significant issue in light of a prior Supreme Court decision, *Kokesh v. SEC,* 137 S. Ct. 1635 (2017).

The underlying case, in which *certiorari* was granted, involves two individual defendants who allegedly raised $27 million from Chinese investors to be used to develop and build a cancer treatment center that did not materialize. The SEC filed an enforcement action in 2016 against the individuals, and eventually through the courts the individual defendants were ordered to pay $26.7 million in disgorgement. The Ninth Circuit affirmed the decision in 2018.

The individual defendants filed a petition to the United States Supreme Court asking for a review of whether the SEC has the actual authority to seek disgorgement as "equitable relief." They argue that Congress had identified the types of relief that may be awarded by an SEC enforcement action to include injunctive relief, equitable relief and certain types of civil monetary penalties, noting that disgorgement does not fit within these areas (equitable relief) and, thus, the SEC does not have the authority to obtain disgorgement. The defendants further urged the court to grant *certiorari* to address the issue that was raised by the court's former decision in the *Korkesh* case. Their brief asserts that the *Korkesh* case found that disgorgement to the SEC is a penalty and the

Korkesh court had declined to consider whether disgorgement could be available as equitable relief in that case. The SEC asserts that disgorgement is an equitable remedy and it has the authority to obtain such relief under the Securities Act and the Exchange Act.

This case is being watched closely based on its potential broad impact on the mechanisms by which the Securities and Exchange Commission pursues its enforcement actions. If the Supreme Court finds that the SEC cannot obtain disgorgement in its enforcement actions in the court system, the SEC will have to significantly alter its current processes. *Liu v. SEC,* 2019 U.S. LEXIS 6599 (2019).

SEC Whistleblower Protections Extend Beyond Employees

The Securities and Exchange Commission (SEC) recently stated in a press release that whistleblower protections extend "beyond employees to protect anyone who seeks to report potential securities violations to the Commission."

The SEC issued the press release to discuss the SEC's filing of a complaint against a company and its principal who, according to the SEC, threatened investors with legal action if they reported the principal's actions to the SEC in violation of SEC Whistleblower rules. The SEC alleged that the company conditioned the return of investment to the investors based on their agreement that they would not inform the SEC of any perceived violations or company misconduct. The company sued two investors who had previously signed the agreement for breach of contract after they subsequently reported the company's activities to the SEC.

The SEC then sued the company and its principal for violating the anti-fraud and whistleblower provisions of the securities laws; specifically, Section §17(a)(1) and (3) of the Securities Act, Section §10(b) of the Exchange Act and rules 10(b)-5(a) and (c) and impeding violation of Rule 21F-17 of the Exchange Act. In addition, the SEC sought disgorgement and pre-judgment interest from the plaintiff's wife because it appeared she illegally used investor funds.

The SEC proved it would continue to support the premise that there is a basic interest in having legal violations reported to the authorities. *SEC Charges Issuer and CEO with Violating Whistleblower Protection Laws to Silence Investor Complaints,* Securities and Exchange Commission November 4, 2019 Press Release, https://www.sec.gov/news/press-release/2019-227.

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Forum Selection Clause

Pennsylvania State Court Rejects Forum Selection Clause in Certificate of Incorporation

In response to the U.S. Supreme Court's decision in *Cyan, Inc. v. Beaver Cty. Emples. Ret. Fund,* 2018 U.S. LEXIS 1912 (2018), which found that state courts retain concurrent jurisdiction for 1933 Securities Act liability actions, some companies contemplating an initial public offering attempted to circumvent the possibility of state court jurisdiction for securities class action lawsuits by adopting a charter provision designating a federal forum for these kinds of suits. In *Sciabacucchi v. Salzburg*, 2018 Del. Ch. LEXIS 578 (Del. Ch. 2018), however, the Delaware court declared unenforceable federal forum selection clauses in a corporate charter. *Sciabacucchi* is currently on appeal to the Delaware Supreme Court.

A Pennsylvania state court adopted the guidance of *Sciabacucchi* and rejected a company's attempts to rely on a forum-selection clause in its Certificate of Incorporation in support of dismissal, which required any suit commenced under the federal securities law to be brought in federal district court. The Pennsylvania state court noted that the parties agreed that the applicability and enforceability of the provision was governed by Delaware law. The court explained that it would defer to the only Delaware case on the issue of enforceability of forum-selection clauses – *Sciabacucchi*. The court also denied the company's attempts to stay proceedings pending the appellate decision in *Sciabacucchi*. *McComas v. Brightview Holdings, Inc. PA C.P. Montgomery Cnty* 2019-07222 (PA C.P. 2019).

Cases Of Interest

Claim Definition

Department of Labor Inspection Request is Not a Fiduciary Claim

The United States District Court for the Southern District of Iowa considered whether a letter from the Department of Labor ("DOL") was a claim under a fiduciary liability policy. Because the letter did not allege a "wrongful act" per the policy, the court held that it was not a "claim."

The insured purchased claims-made fiduciary liability policies for the 2014-2016 period and the 2016-2017 period. The definition of "claim" included "a written notice of commencement of a fact-finding investigation by the U.S. Department of Labor . . . against an Insured for a Wrongful Act." The policies defined a "wrongful act" to include: "1) any breach of duties imposed by ERISA committed or allegedly committed by an Insured; 2) any negligent act, error, or omission in Administration of any Plan committed or allegedly committed by an Insured; or 3) any other matter claimed against an Insured solely by reason of the Insured's services as a fiduciary."

During the first policy period, the insured received a two-page letter from the DOL, requesting inspection of its various employee stock ownership plan documents pursuant to a DOL investigation. The insured did not notice the DOL letter at the time. During the second policy period, a former employee filed suit on behalf of a stock plan at issue. The insured later received another letter from the DOL, advising of the insured's possible breach of fiduciary obligations and violation of ERISA provisions. The insured provided prompt notice of both the suit and second DOL letter.

Upon review, the court refused to find a "wrongful act" alleged in the initial DOL letter, which it determined was "not a notice of investigation for a breach or alleged breach" of the insured's duties under ERISA where there was no assertion of an ERISA violation or any mention that a violation was suspected. The court also determined that the first letter was not a notice of investigation, per the policy language, "for any other matter

claimed against an Insured solely by means of the Insured's service as a fiduciary." The insurer argued that the letter's request for records and demand for on-site examination alleged a "wrongful act" per the policy. However, the court found that such an interpretation ignored the that the definition required a violation of a legal obligation, which was not indicated by the DOL letter. The court concluded that the initial letter was not a claim and thus, the insured's failure to give notice thereof was not a valid basis for denial. *Telligen, Inc. v. Atl. Specialty Ins. Co.*, 2019 U.S. Dist. LEXIS 175702 (S.D. Iowa 2019).

Fraudulent Instruction

Combination of Communications Constitute Fraudulent Instruction and Caused Direct Loss

The United States Court of Appeals for the Eleventh Circuit affirmed that a fidelity policy covered the insured's loss of funds wired to phishing scam fraudsters. The court held that the insured suffered a direct loss despite the involvement of the insured's bank and an individual purporting to be outside counsel. The court further held that the insured received a "fraudulent instruction" to transfer money per the policy language.

The insured's controller received an email purporting to be from its managing director. The email asked the controller, in furtherance of the insured's secret and "key acquisition," to wire money pursuant to details that an outside attorney would provide. The email gave the name of this supposed attorney and requested that the controller treat the matter confidentially and "deal solely" with the attorney. The controller then received an email purporting to be from the attorney, who specified the transfer amount and remittance details to a bank in China. Once the controller approved the transfer, the fraud prevention service of the insured's bank requested verification of the transfer's legitimacy. In response, the controller confirmed with the attorney that the managing director had approved the transfer and relayed this to the bank. The controller discovered the request was fraudulent the next day.

At issue were: 1) whether the insured had received a "fraudulent instruction" per the policy and 2) whether the loss directly resulted from the purported managing director's email. The policy required that the "fraudulent instruction" "direct a financial institution to...transfer...money...from [the insured's] account." The insurer asserted that no "fraudulent instruction" was involved, since the purported managing director's email did not specify an amount of money or recipient. Instead, only the purported outside attorney's email contained these details such that no coverage was afforded. Per the policy's definition, a "fraudulent instruction" needed to come from a sender purporting to be an employee. In rejecting this "divide-and-conquer approach," the court determined that the combination of both emails "unambiguously" qualified as a fraudulent instruction. Further, the insured's loss directly resulted from the managing director's email pursuant to Georgia precedent, which permitted a proximate cause "direct" loss analysis. In finding this, the court refused to see the controller's communications with the outside attorney and the bank's involvement as severing the causal chain. Both events, according to the court, were foreseeable consequences of the purported managing director's email, since it directed the controller to deal with the attorney. *Principle Sols. Grp., LLC v. Ironshore Indem., Inc.,* 2019 U.S. App. LEXIS 36350 (11th Cir. 2019).

Insured Parties

Medical Group Not an Insured Under Affiliate's Policies

The Court of Appeals for the Eleventh Circuit affirmed a lower court ruling for the insurer that the insurer was not required to provide coverage to a medical group under a Professional Employer Organization's (PEO) Employment Practices Liability (EPL) policy because the group did not have a valid contract under state law with the PEO.

The medical group, which utilized the services of the PEO, submitted two claims made against it to the PEO's EPL insurer. The insurer initially defended the group under a reservation of rights, but later denied the claim saying that the medical group did not have a written employee leasing agreement with the PEO at the time of the claim and was not an insured. The medical group lost its suit at the district court level and subsequently appealed.

The 11th Circuit affirmed, finding that the documents the medical group presented; an email, a brochure, and a letter to an insurance company designating the PEO as its insurance agent, did not constitute a written agreement under Florida law. These documents did not describe the co-employer relationship between the parties, reserve control over the employees for the PEO, reserve ability to hire, fire, discipline or reassign employees for the PEO or require the PEO to provide written notice on the relationship between the parties to the leased employees as required by Florida statute. Therefore, as there was no written agreement between the parties, the district court was correct in granting summary judgment to the insurer. *THM Med. Servs., LLC v. National Union Fire Ins. Co.,* 2019 U.S. App Lexis 35954 (11th Cir. 2019).

Notice

Claim was Late Despite Continuity of Coverage

The Court of Appeals of Ohio upheld a lower court's ruling that a claims-made policy barred coverage for a claim first made in a prior policy, despite the fact that there was continuity of coverage with the same insurer.

In January 2014, the insured received a letter from the prior employer of various new hires. The letter requested that the insured acknowledge certain post-employment obligations those new hires owed to the prior employer. One month later, the prior employer filed suit against the insured and several individuals. The insured did not report the matter to its insurers until August 2015, when it formally advised its Directors & Officers Liability ("D&O") insurer. The D&O insurer had written three consecutive claims-made policies for the insured for the periods 2013-2014, 2014-2015, and 2015-2016. The claims-made policies contained a notice provision dictating that: 1) written demands made during the policy period shall be noticed prior to the end of the policy period; or 2) civil proceedings made during the policy period shall be noticed as soon as practicable after a member of the control group has knowledge of the Claim, but in no event later than 90 days post expiration. The policies contained a savings clause that stated: “the Insureds failure to report a Claim pursuant to (1) above shall not negate the right to report a Claim pursuant to (2) above under this Policy or any renewal thereof.”

The insurer denied coverage on the basis that the lawsuit was not timely noticed where the suit was filed during the 2013-2014 policy but not noticed until the 2015-2016 policy period. The insured sued the insurer for breach of contract for failure to defend and indemnify and the trial court granted the insurer’s motion to dismiss.

On appeal, the insured cited to various cases that had confirmed coverage based on lack of prejudice and/or continuity of coverage.

The court, however, distinguished all of those cases because the policy wording was significantly different. The court rejected the notice prejudice rationale because of the policy’s strict date requirements for notice.

The court also considered the impact of the savings clause on coverage. It stated: “reading definitions of claim together with the “savings clause,” the “savings clause” provides that if the insured fails to report a written demand for relief, that failure will not negate the insured’s right to report a civil proceeding under the policy or any renewal of the policy.” The insured argued that because the letters constituted demands, they invoked the savings clause, such that failure to report the letters would not preclude the subsequent notice of the lawsuit. The court rejected that argument for two reasons. First, the letters were not “claims” because they did not demand anything. Second, the insured’s interpretation of the savings clause rendered the second part of the notice provision meaningless. The court affirmed the lower court’s grant of the insurer’s motion to dismiss. *ISCO Indus. V. Great Am. Ins. Co.,* 2019 Ohio App. LEXIS 4949 (Ohio 1st Dist. 2019).

Conduct Exclusion

Third-Party Conduct Does Not Trigger the Fraud Exclusion

The United States District Court for the Southern District of New York held that the fraud exclusion in an errors and omissions policy was not triggered when the fraud was committed by third-party fraudulent actors and not the insured.

The insured is a global provider of software and software-enabled services that provides, among other things, business processing management. For several years, the insured acted as fund administrator for its client, an investment fund. The insured was responsible for holding the client’s funds and dispersing them under the client’s direction. Criminals used “spoofed” e-mail addresses to send forged transfer requests to the insured. The insured received the wire transfer requests and—believing them to be from the client— processed them according to the terms of its contract with the client.

The client sued the insured and alleged that the insured was grossly negligent in handling

The court rejected the notice prejudice rationale because of the policy's strict date requirements for notice.

the client's funds, breached its services contracts, and breached the implied covenant of good faith and fair dealing. The insured provided timely notice of the claim to its E&O insurer, which agreed to provide a defense but denied indemnity coverage for the settlement of the claim. The insured subsequently filed suit and sought a determination that coverage was available under the policy.

The conduct or fraud exclusion in the policy excludes coverage for losses "alleging, arising out of, based upon or attributable to a dishonest, fraudulent, criminal or malicious act, error or omission, or any intentional or knowing violation of the law; provided, however, [the insurer] will defend Suits that allege any of the foregoing conduct, and that are not otherwise excluded, until there is a final adjudication against an Insured . . .." The insurer argued that the "plain reading of the first clause before the 'provided, however' clause dictates that [the exclusion] applies not only to 'dishonest, fraudulent, criminal or malicious act, error or omission, or any intentional or knowing violation of the law; committed by [the insured], but also broadly to such acts committed by third-party fraudsters, such as here." The court disagreed and concluded that the insurer's interpretation fails when the sentence in the exclusion is read in its entirety. The court determined that "coupling the first clause with the 'provided, however' clause of the same sentence clearly indicates that [the exclusion] applies only to dishonest, fraudulent, criminal, or malicious acts committed by [the insured], and not to these such acts committed by third-party fraudsters." The court added that this interpretation is most likely what the parties intended when they entered into the policy. In addition, the court found that the insurer had been acting in bad faith when it changed its original position that a final adjudication that the insured acted with the third-party fraudsters could exclude indemnity coverage and trigger the insurer's right to recoup defense fees. The court held that the fraud exclusion did not apply to fraudulent conduct by third parties, and, therefore, did not preclude indemnity coverage for the insured in the underlying claim. *SS&C Tech. Holdings v. AIG Specialty Ins. Co.,* 2019 U.S. Dist. LEXIS 194196 (S.D.N.Y. 2019).

Contract Exclusion

Breach of Contract Exclusion Renders Errors & Omissions Coverage Illusory

The United States Court of Appeals for the Seventh Circuit determined that a broad breach of contract exclusion inserted by endorsement rendered the insured's Errors & Omissions and professional liability coverage illusory.

The insured contracted with a customer to build an anaerobic digester. Thereafter, the customer sued the insured for breach of contract, alleging that the insured "failed to fulfill its design duties, responsibilities, and obligations under the contract in that it did not properly design substantial portions of the structural, mechanical, and operational systems of the anaerobic digester." The insured noticed the lawsuit to its E&O insurer, which initially provided a defense, but later denied coverage asserting that the policy's breach of contract exclusion, which applied to claims "based upon or arising out of" breach of contract, completely barred coverage for the lawsuit.

The insurer sought declaratory judgment based on the exclusion. The insured maintained that the exclusion was so broad that it effectively rendered coverage illusory. The district court held that the breach of contract exclusion did not render coverage illusory because coverage would still apply to third party claims. The Seventh Circuit disagreed, ruling that the exclusion "is extremely broad" and excludes coverage for all claims for professional liability, even third-party claims. The court stated that "Wisconsin courts have made clear that the 'arising out of' language is broadly construed." The court noted that "all that is required is some causal relationship between the injury and the event not covered which sweeps in third-party claims as well when so related."

Consequently, the court ruled that the contract exclusion rendered the professional liability coverage in the E&O policy illusory and the policy should be reformed to meet the insured's reasonable expectations in securing that coverage *i.e.,* insurance "designed to insure members of a particular professional group from liability arising out of the special risk such as negligence, omissions, mistakes and errors inherent in the practice of the profession." The court remanded the case to the district court to consider the question of the insured's reasonable expectations in securing the E&O coverage. *Crum & Forster Specialty Ins. Co. v. DVO, Inc.,* 2019 U.S. App. LEXIS 28714 (7th Cir. 2019).

Wage & Hour Exclusion

Court Interprets Wage & Hour Exclusion Under an EPLI Policy

The owner of fast-food restaurants had purchased an employment practices liability insurance (EPLI) policy. After being named in an underlying class action lawsuit alleging various Labor Code violations, the policyholder sought coverage under its EPLI policy. The insurer and the denied coverage and the policyholder filed a suit for damages alleging the insurer breached its contract and the implied covenant of good faith and fair dealing.

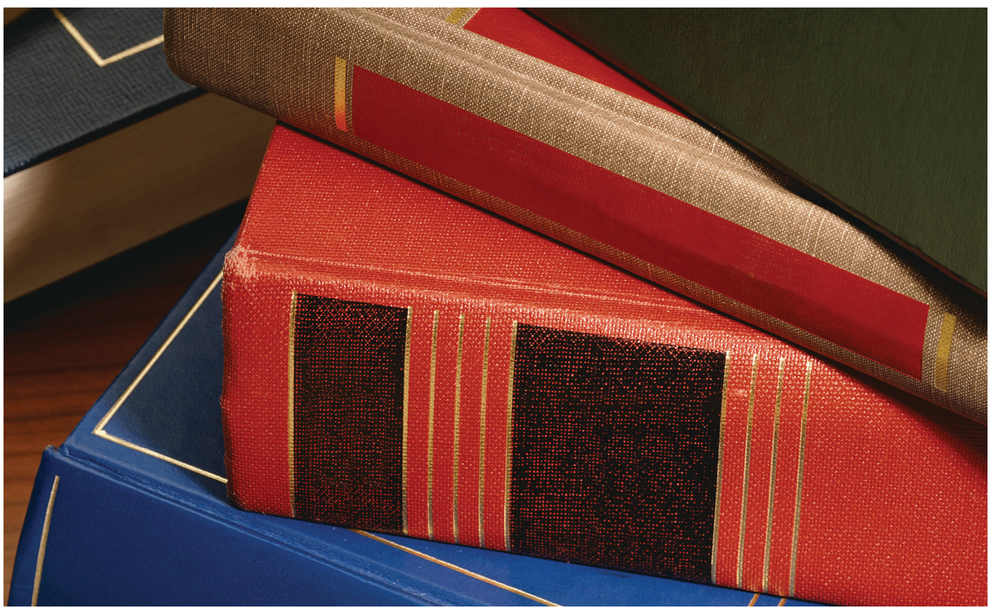
The issue in the coverage suit is the scope of the EPLI policy's wage & hour exclusion and whether, and to what extent, the allegations of the underlying suit fall within the exclusion. After reviewing the issues, the court found that the wage & hour exclusion did not apply to all the allegations in the underlying class action lawsuit. The exclusion states:

> This policy does not cover any Loss resulting from any Claims based upon, arising out of, directly or indirectly connected or related to, or in any way alleging violations of any foregoing, federal, state, or local, wage and hour or overtime law, including without limitation, the Fair Labor Standards Act; ...

The plaintiff focused on two sets of allegations in the underlying lawsuit it asserted fell outside the exclusion:

1. Allegations that the plaintiff failed to reimburse its delivery drivers for mileage expenses, certain work travel-related costs and cell phone expenses; and

2. Allegations that the plaintiff failed to obey the statutory requirement that certain information be included on each wage statement.



The court said that the primary question was whether the specific factual allegations in the underlying lawsuit evidence claims that "arise, out of, are directly or indirectly connected or related to, or in any way allege violations of any state wage and hour or overtime laws." This required the court to interpret the meaning of the phrase "wage and hour law," which the policy did not define.

In its analysis, the court looked into the common dictionary meanings of "wages" and "hour," and the purpose of the statutes, whether the words "wages" or "hours" appear in the statutes (while not dispositive, the court observed that one would not expect them to be wage or hour laws if the words were not even in the statutes), the underlying claims, and the relevant case law.

Consequently, the court ruled that the contract exclusion rendered the professional liability coverage in the E&O policy illusory and the policy should be reformed to meet the insured's reasonable expectations in securing that coverage.

The court decided that the underlying lawsuit's business expenses reimbursement claim, as well as the California Business and Professions Code Section 17200 ("Unfair Competition") claims and the California Private Attorneys General Act (PAGA) claims, were potentially within the policy's scope. *Southern Calif. Pizza Co, LLC v. Certain Underwriters at Lloyds, London,* 2019 Cal. App. LEXIS 900 (2019).

California Insurance Code

California Insurance Code 533.5 Precludes Insurance Coverage for Unfair Competition or False Advertising Actions

The United States District Court for the Central District of California held that California Insurance Code Section 533.5 precludes a defense or indemnity for any claim brought by the California Attorney General ("AG") under California's Unfair Competition Law ("UCL") or False Advertising Law ("FAL") for the recovery of a fine, penalty, or restitution.

In the underlying matter, the AG's office filed an action against the insured for UCL and FAL violations, seeking injunctive relief, restitution, and civil penalties. The insured noticed its D&O insurer which initially disclaimed coverage, but subsequently defended under a full reservation of rights. Over a year into the underlying matter, the AG advised the insurer that pursuant to Insurance Code 533.5, coverage for the action was prohibited. The statute, in relevant part, prohibits an insurer from providing any defense or indemnity to an insured in a criminal proceeding brought by the AG pursuant to the FAL or UCL.

After a series of exchanges between the insurer and the AG's office, the insurer denied coverage under Insurance Code 533.5. In the instant coverage dispute, the court determined "the language of [Section 533.5] clearly and explicitly establishes that there was no potential for coverage and, consequently, no duty to defend in the underlying action." The court rejected the insured's arguments that it detrimentally relied upon the insurer's action in initially defending the claim. It found that the insurer "chose to advance defense costs for Plaintiff in the underlying action until the applicability of Section 533.5 to the entire underlying action became clear." The court also determined the AG's letters to the insurer "resolved any remaining uncertainty regarding the potential for coverage and, therefore, gave [the insurer] adequate grounds to terminate its defense of [the insured] ...and to later seek reimbursement of all amounts already paid." On the issue of indemnification, the court found that "where there is no duty to defend, there can be no duty to indemnify" and noted the "statute explicitly precludes indemnification for any fine, penalty, or restitution in any action brought under the UCL or FAL by the Attorney General or another state prosecuting authority." *Adir Int'l, LLC v. Starr Indem. & Liab. Co.,* 2019 U.S. Dist. LEXIS 155321 (C.D. Cal. 2019).

Securities Cases

Connecticut State Court Grants Motion to Strike Securities Act Claims

The Superior Court of Connecticut (Judicial District of Stamford) granted the defendants' motion to strike the plaintiff's complaint in a putative class action alleging violations of the Securities Act of 1933 ("Securities Act") in connection with disclosures made for an initial public offering ("IPO") of debt securities. The court concluded that the revenue declines, which the defendants did not disclose, were no more than ordinary business fluctuations.

The plaintiff alleged that the defendants violated the Securities Act by failing to disclose third quarter declines in one of its business segments and the corresponding effects on the company's financial performance. The plaintiff alleged that various financial documents incorporated by reference in the IPO prospectus contained misleading statements concerning the company's third quarter 2017 performance. The plaintiff alleged that the defendants failed to disclose the company's decreasing revenues and sales for some of its services, which affected its net income. The plaintiff also alleged that the declines were "trends" or "uncertainties" that triggered an obligation to make additional disclosures pursuant to Item 303 of the Securities and Exchange Commission Regulation S-K (17 CFR § 229.303). Further, the defendants were allegedly aware of these issues at the time of the IPO. The defendants countered that Item

303 did not require disclosures of third quarter performance because the declines in performance during that quarter were not "trends" or "uncertainties" as defined in Item 303 and that it was not unreasonable for the defendants to conclude that these would not have a materially adverse impact. The defendants also contended that their statements about recurring revenues and sales were truthful and that none of the alleged omissions were material.

The court determined that "[n]othing in the plaintiff's complaint suggests that this decline was part of an ongoing pattern, nor that it was caused by a persistent condition affecting [the company's] business rather than ordinary, quarter-to-quarter business fluctuations." Accordingly, it found the defendants under no independent duty to disclose the alleged declines during a quarter that had not yet closed and emphasized that "accurate statements of historical fact cannot form the basis of a securities claim." In finding for the defendants, the court held that the company was "under no obligation to disclose these alleged declines prior to, or contemporaneously with, the IPO." *City of Livonia Retiree Health & Disability Benefits Plan v. Pitney Bowes, Inc.,* No. X08 FST CV 18 6038160 S (Conn. Super. Ct. 2019).

Motion to Dismiss 10b-5 Case.

Securities Class Action Dismissed Against Social Media Company

The United States District Court for the Northern District of California dismissed without prejudice the privacy related securities class action which followed a data mining scandal and General Data Protection Regulation (GDPR) readiness/compliance issues involving a social media giant. The court concluded that the plaintiffs had not shown the requisite misleading intent or recklessness to support a valid securities claim.

The complaint was a consolidation of two separate class actions filed against the social media company and individual defendants. The initial suit followed the adverse publicity that arose after the company's disclosure that user data had been accessed by a third-party firm to target users with political advertisements. The securities suit alleged that the company had misled investors about the protection of user information and privacy policies. The second suit focused upon the representations concerning the impact on the company (including user slowdown) by the newly imposed privacy regulation, GDPR. The consolidated complaint alleged a total of thirty-six individual misleading statements by the company downplaying the impact of the data use and GDPR situations. In reviewing the statements, the court determined that the complaint failed to specifically identify instances where the company or its executives knowingly made such statements and noted that some were forward-looking predictions or expressions of corporate optimism. The court addressed a particular individual statement which could be shown to be false, in which the company's chief operating officer ("COO") stated in a 2017 interview, "When you share on [the social media site], you need to know that no one's going to steal our data. No one is going to get your data that shouldn't have it.... you are controlling who you share with." The court did fully dismiss the case, notwithstanding this one actionable statement, on the basis that the plaintiffs had not shown that the COO acted with misleading intent or recklessness needed to support a valid securities claim.

Given that the court issued its dismissal without prejudice, the case is expected to be closely watched for the plaintiffs to replead their allegations with more particularity. *In re Facebook, Inc. Securities Litigation,* 2019 U.S. Dist. LEXIS 166027 (N.D. Cal. 2019).

Other Cases of Interest—Standing

Court Rejects Settlement in Cyber Case where Parties Lacked Standing

On a motion to approve a class-action settlement, which was unopposed, the court declined to approve the settlement on the basis there was no evidence of injury, thus the plaintiffs lacked Article III standing.

In this matter, an employee of a mental and behavioral services company, which provided services to veterans and others, sent an email which contained personal information of approximately 130 current and former clients. The email was only distributed internally to current employees of the company. Several people whose information had been shared sued on behalf of a class of all those whose information had been shared, alleging negligence and violations of several states' laws. While the defendants moved to dismiss the complaint for lack of Article III standing, amongst other things, the parties subsequently agreed to settle the matter. However, the court declined to approve the $60,000 settlement or award attorneys' fees on the grounds the plaintiffs lacked standing. In reaching this conclusion, the court addressed the role and limits on federal courts, noting that "[o]ne critical limit set forth in Article III of the United States Constitution is that all suits filed in federal court must be 'cases and controversies of the sort traditionally amenable to, and resolved by, the judicial process'." The court further added that "a court is powerless to approve a proposed class settlement if it lacks jurisdiction over the dispute, and federal courts lack jurisdiction if no named plaintiff has standing." In discussing the standing requirements, plaintiff must allege an "injury in fact" which is "an invasion of a legally protected interest that is concrete and particularized and actual or imminent, not conjectural or hypothetical" and also noted that "although imminence is concededly a somewhat elastic concept, it cannot be stretched beyond its purpose, which is to ensure that the alleged injury is not too speculative for Article III purposes." While the court did note other cases where plaintiffs established standing against an entity that held their personal identifying information in a "data breach" by showing an increased risk of future identity theft, the court distinguished those cases by noting at least one named plaintiff in those cases had alleged misuse of his or her information by the data thief. Furthermore, in these "data breach" cases, the data was "stolen by hackers or cyber criminals who had intentionally targeted the data." The court distinguished between personal information targeted by a hacker where the purpose of the hack is to fraudulently use the stolen information at some point, thereby creating a substantial risk of harm which satisfies the injury requirement, versus situations where courts have determined "in the absence of an allegation or evidence that an unauthorized third party intentionally stole the data at issue, courts have concluded that the risk of identity theft is too speculative to support Article III standing."

Applying these principles, the court found there were no allegations the data was misused or that a class member's identity was stolen because of the breach. The court also took notice that the errant email was shared with employees of the company who deal with sensitive information of all kinds and were at risk of being fired if they did anything untoward with the email. The court concluded plaintiffs "cannot manufacture standing merely by inflicting harm on themselves based on their fears of hypothetical future harm that is not certainly impending." *Steven v. Carlos Lopez & Assocs.,* 2019 U.S. Dist. LEXIS 203621 (USDC SDNY 2019).

The court further added that "a court is powerless to approve a proposed class settlement if it lacks jurisdiction over the dispute, and federal courts lack jurisdiction if no named plaintiff has standing."

Cyber Corner

Is A Federal Privacy Law Coming in 2020?

While the end of 2019 on Capitol Hill had the nation's attention focused on the impeachment hearings, three separate Congressional efforts to enact a Federal privacy law emerged to comparatively little fanfare by the media and the public. On November 26, 2019, Senator Maria Cantwell (D-WA) introduced the Consumer Online Privacy Rights Act ("COPRA"), while Senator Roger Wicker (R-MS) introduced the United States Consumer Data Privacy Act of 2019. Finally, on December 18, in the House Energy and Commerce Committee released a bipartisan staff-level draft privacy bill.

The COPRA bill introduced by Senator Cantwell proposes several privacy protections already seen in various state privacy laws and regulations, including an individual's rights to view their data and be "forgotten" through deletion of the data. In additional, the bill proposes increased fines for privacy offenses, and proposes stringent permission requirements on companies seeking to collect sensitive data and biometric information. Additionally, COPRA proposes expansion of the Federal Trade Commission's power through the creation of a specific bureau of privacy within the FTC. Consumers would also have a private right of action under the proposed law.

Senator Wicker's bill proposes many measures and protections similar to COPRA and proposes heightened corporate accountability through designated privacy officers whose focus would be compliance with the new law. However, the Wicker bill differs in two key areas that raise questions as to whether a compromise could be reached in the Senate.

First, the Wicker proposal does not include a private right of action for consumers. Although currently absent from the Wicker bill, the Senator has indicated he would consider amending to include a narrow private right. The second major difference from COPRA is that the Wicker proposal expressly seeks to pre-empt state privacy laws in favor of a new Federal standard. While a singular, national standard for privacy is seen by many as a positive over a fifty-state patchwork approach, critics of the Wicker bill contend that the pre-emption language is designed to protect large technology firms and data aggregators from the mandates of the California Consumer Privacy Act, which went into effect on January 1, 2020.

For its part, the bi-partisan bill released by the House Energy and Commerce Committee is comprehensive in scope, however, much of the language and particulars of the proposed law was not completed before its release and brackets were used where language had not yet been agreed upon by the Committee. Among the language included in the released draft, the bill would provide the FTC with increased authority, including the creation of a Bureau of Privacy, as also proposed in COPRA. Notably, the House draft is silent on the issues of preemption and private rights of action that distinguish the two Senate proposals.

Lessons Learned: While there are varying opinions on whether a Federal privacy law and standard is desirable, there is no question the bills and bill draft released in late 2019 are the furthest Congress has gone towards any such standard. There is a significant amount of overlap and common ground between the three Congressional initiatives, including the competing Senate bills, which suggests that agreement on a privacy bill may not be far. However, the preemption and private right of action issues are significant, potentially polarizing, differences in the Senate drafts that the bi-partisan House draft has not addressed. Whether those issues rise to the level of wedge issues that prevent a Federal law from being approved remains to be seen and will be closely monitored throughout 2020.

SEC Filings, Settlements and Judgments

Filings

In November 2019, the SEC amended a complaint to charge four former executives of **Outcome Health** with fraud. The SEC's amended complaint charges former CEO Rishi Shah, former President Shradha Agarwal, former CFO Brad Purdy, and former Executive VP Ashik Desai with violations of the antifraud provisions of the securities laws. The SEC seeks return of ill-gotten gains plus interest, penalties, injunctive relief, and officer and director bars. The U.S. Attorney's Office for the Northern District of Illinois and the DOJ announced criminal charges against Shah, Agarwal, Purdy and Desai along with two others.

In November 2019, the SEC announced amended fraud charges against **Collectors Café** and its CEO Mykalai Kontilai. The amended complaint alleges that the company and Kontilai violated whistleblower protection rules and made misrepresentations to investors. The SEC seeks injunctive relief, disgorgement plus prejudgment interest, and penalties. Kontilai's wife is also named as a relief defendant.

In December 2019, the SEC announced fraud charges against the former COO, William Eric Meek, and former CFO, Bobby Peavler, of **Celadon Group, Inc.** The SEC seeks permanent injunctions, monetary penalties, and officer and director bars against both individuals.

Settlements & Judgements

In October 2019, the SEC announced that it settled charges against **FAB Universal Corp.'s** CEO, Christopher J. Spencer, and CFO, John Busshaus. Without admitting or denying the allegations, Busshaus and Spencer agreed to bifurcated settlements. Disgorgement, prejudgment interest, and civil penalties are to be determined at a later date.

In October 2019, the SEC announced that it entered final judgments by consent against **Lek Securities Corp.** and its CEO, Sam Lek. The judgment against Lek Securities imposes a three-year injunction requiring termination of business with foreign customers potentially engaged in manipulative trading and largely prohibiting it from providing intra-day trading for foreign customers. The company also agreed to a censure and to retain an independent compliance monitor for three years. The company, along with Sam Lek, agreed to permanent injunctions from violating certain provisions of the federal securities laws. Lek Securities will also pay a $1 million penalty and $525,892 in disgorgement and Sam Lek will pay a $420,000 penalty. Sam Lek also agreed to associational and penny stock bars with a right to reapply after 10 years.

In October 2019, the SEC announced a final judgment on fraud charges against Bobby Dwayne Montgomery, former Chief Business Officer of **Osiris Therapeutics**. Montgomery consented to a judgment enjoining him from future violations of the securities laws and requiring payment of a $40,000 civil penalty.

In November 2019, the SEC settled fraud allegations involving **MiMedx Group Inc.** Without admitting or denying the allegations, MiMedx agreed to a settlement requiring payment of a $1.5 million penalty. The litigation continues against former executives CEO Parker H. Petit, CFO Michael J. Senken, and COO William C. Taylor.

In December 2019, the SEC announced that it filed and settled certain fraud charges against **Iconix Brand Group, Inc.,** and its former CEO Neil Cole, CFO Warren Clamen, and COO Seth Horowitz. Without admitting or denying the allegations, Iconix agreed to injunctive relief and a $5.5 million penalty. Horowitz consented to injunctive relief, a permanent director and officer bar, and agreed to pay disgorgement and prejudgment interest of $147,000 plus a to be determined amount of penalties. Clamen agreed to cease and desist from future violations and agreed to pay disgorgement and prejudgment interest of nearly $50,000 plus a $150,000 penalty. Clamen is also suspended from appearing and practicing before the Commission as an accountant, with the option to apply for reinstatement after three years. The litigation against Cole continues and the SEC is seeking monetary and injunctive relief including a permanent director and officer bar and reimbursement of incentive-based compensation under SOX.

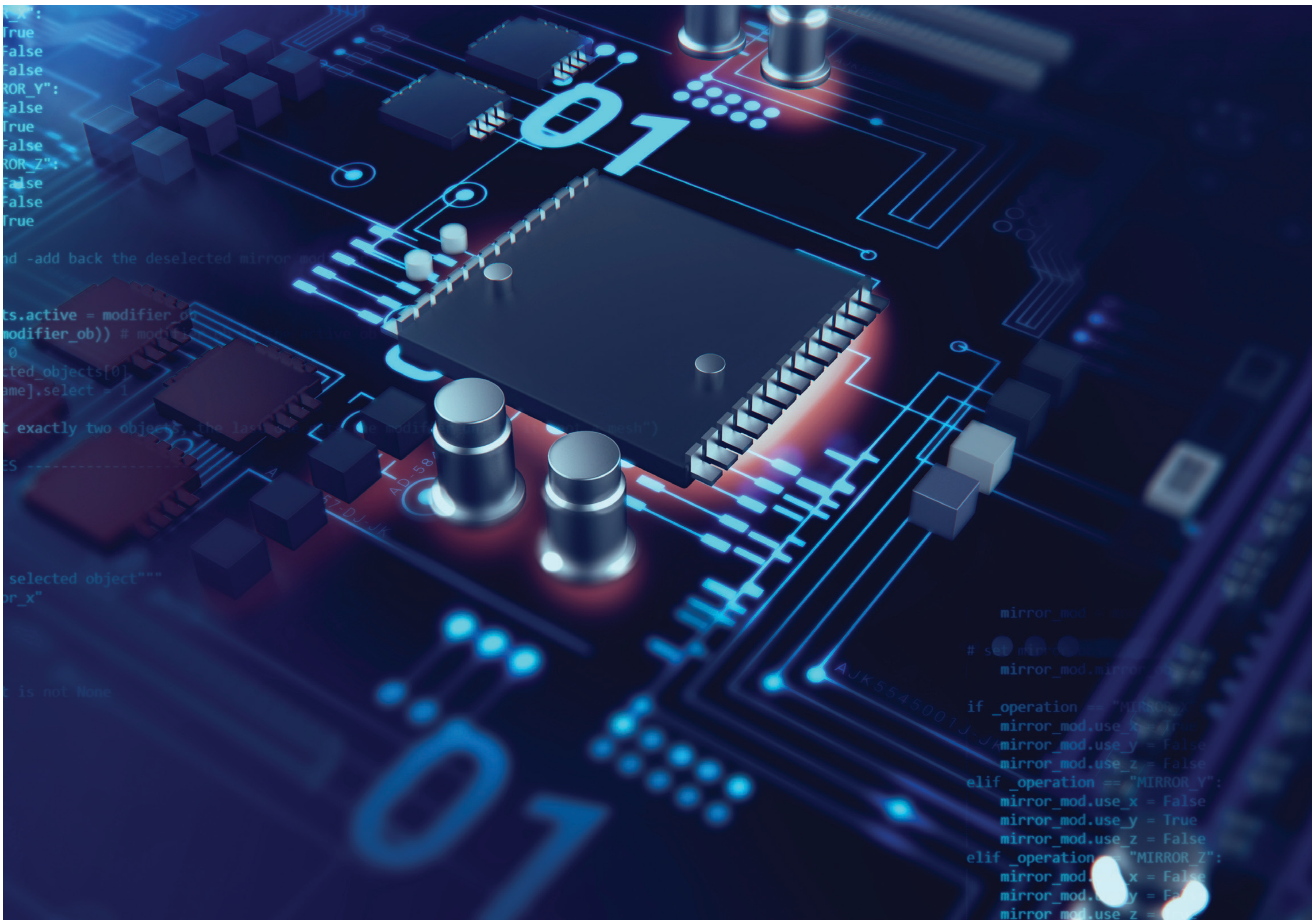
In December 2019, the SEC entered a final judgment against Harpreet Grewal, the former CFO of **Constant Contact, Inc.** Without admitting or denying the allegations, Grewal consented to entry of final judgment enjoining him from future violations of the securities laws and requiring him to pay disgorgement and prejudgment interest of $250,000 and a $100,000 civil penalty.

FCPA Enforcement Actions

In November 2019, the SEC announced that it charged Jerry Li, the former managing director of a US based direct selling company in China, with violations of the FCPA. The SEC alleges that Li orchestrated a bribery scheme with Chinese governmental officials to obtain licenses and curtail governmental investigations of the company's business practices. The SEC seeks permanent injunctive relief and monetary penalties against Li.

In December 2019, the SEC announced it settled FCPA charges against **LM Ericsson**. The SEC alleged that Ericsson bribed officials in Saudi Arabia, China and Djibouti to secure roughly $427 million in business, and that it also violated the FCPA in Vietnam, Indonesia and Kuwait. To settle the allegations, Ericsson agreed to pay more than $539 million in disgorgement and prejudgment interest. Ericsson also agree to pay a $520 million penalty to settle parallel criminal charges brought by the DOJ. Ericsson Egypt plead guilty to conspiracy to violate FCPA provision, and the company agreed to retain an independent compliance monitor for at least 3 years.

In December 2019, the SEC announced that it settled FCPA charges against Tim Leissner, a former **Goldman Sachs Group Inc.** executive. The SEC alleged that Leissner utilized a third-party intermediary to bribe officials in Malaysia and the Emirate of Abu Dhabi in exchange for business. Leissner consented to an order requiring disgorgement of $43.7 million, which is offset by amounts paid pursuant to settlement of a parallel criminal action by the DOJ. Leissner also agreed to be permanently barred from the securities industry.



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