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COVID-19–Related D&O Litigation

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At the time of writing, there are around a dozen COVID-19–related lawsuits against directors and officers and/or public companies alleging actions that could trigger directors and officers (D&O) coverage for defense costs and awards. These COVID-19 D&O suits are falling into two general categories, as well as a potential third.

The first includes litigation arising out of a fall in the company's stock price—commonly called a stock drop suit. Stock drop suits are sometimes brought derivatively by shareholders on behalf of the company against the directors and officers alleged to have engaged in wrongdoing at the expense of the company. The suits can also be brought against the company itself, not just its directors and officers.

The second category includes failed mergers and acquisitions that are blamed on COVID-19.

A potential third category would be D&O suits alleging that the company engaged in an acquisition or merger that was too expensive—shareholders of the acquiring entity would demand a "bump down" in the price—or that was too cheap—shareholders of the acquired entity demand a "bump up" in the price.

Also expected are disclosure issues related to the pandemic triggering heightened scrutiny not just from shareholders but also from regulators and state attorneys general.

Side A Litigation

Following is a discussion of some of the more significant recently filed COVID-19–related lawsuits that fall within typical Side A (insured directors) insuring agreement language within a D&O policy.

Local 464A United Food & Commercial Workers Union Pension Fund v. Antonellis, Case No. 2020–0376 (filed in the Court of Chancery of the State of Delaware on May 15, 2020), is a class-action shareholder suit that alleges that directors of Xperi Corporation, which is publicly traded on the NASDAQ, failed to fulfill their fiduciary obligations to its stockholders regarding a merger to become a subsidiary of XRAY-TWOLF Holdco Corporation. In the transaction, Xperi and TiVo would combine in an all-stock merger transaction. Xperi, however, would be the accounting acquirer, and TiVo stockholders were to receive a premium for their shares based on the share

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price at the time of the announcement. This entity would then become a TiVo subsidiary.

Specifically, the shareholder plaintiffs allege that, after the deal was announced on December 18, 2019, the Xperi Board failed to meet and reconsider the merger agreement in light of the COVID-19 pandemic—whether the pandemic caused a material adverse effect (MAE) and/or intervening event (IE). A determination of a MAE would allow the Board to terminate the agreement. A determination of an IE would permit the Board to change its recommendation regarding the merger.

The suit goes on to allege that the Board failed to act in good faith in refusing to consider—"summarily dismissing"—an all-cash acquisition proposal from Metis Ventures LLC. The suit alleges that conflicted Xperi management and directors did not recuse themselves from the Board's dismissal of the Metis proposal. The suit further alleges that the Xperi Board intentionally made materially misleading disclosures and deliberately omitted relevant and material information from the proxy.

Each count of the Xperi plaintiffs" class-action complaint alleges a breach by the directors of their fiduciary duty of loyalty. This is a typical Side A claim—insured persons alleged to have committed wrongful acts that result in a claim for loss from those wrongful acts. Here, where the insured directors are alleged to have breached their fiduciary duty of loyalty, the company cannot indemnify the directors for the alleged breach. The Xperi plaintiffs seek "appropriate equitable relief," class damages, and attorneys' fees, expenses, and costs, which can be substantial.

Since coverage language in D&O policies can vary from form to form, and this type of insurance is also frequently customized to the specific insured's needs and claim history, it might be expected that Xperi's D&O insurer would provisionally accept tender of the claim and negotiate defense-cost reimbursement with the defendant directors. If the matter doesn't settle, and there is a final adjudication that the directors, in fact, breached their duty of loyalty to the shareholders, then the claim would likely be covered. It is possible, however, that, under applicable law, a final adjudication that the directors gained profit or advantage to which they were not entitled would render the claim uninsurable, due to any applicable exclusion in the policy for illegal profit or remuneration.

The derivative shareholder lawsuit *Beheshti v. Kim,* Case No. 2:20-cv-01962 (filed in the U.S.D.C., E.D. Penn., on April 20, 2020), alleges breaches of fiduciary duty by Inovio Pharmaceuticals' directors and officers along with allegations of unjust enrichment, abuse of control, gross mismanagement, and waste of corporate assets. In brief, the suit asserts that Inovio's directors and officers made false statements that they had developed a COVID-19 vaccine, which they further asserted would be ready for human trials as early as April 2020.

Inovio's share price leapt from $4.15 per share at the close of trading on February 14, 2020, to a high of $19.36 per share on March 9, 2020. That same day, an online newsletter published by Citron suggested Inovio was engaged in fraud by making "the ludicrous and dangerous claim that [it] designed a vaccine in 3 hours." In reality, it turned out, Inovio only had an early stage prototype of a potential vaccine—a vaccine construct—that could lead to a viable vaccine. Later that same day, Inovio clarified via Twitter that it had not developed a full-fledged vaccine.

Inovio's stock began a "freefall," dropping from $14.09 per share to $5.70 per share in just a few days. This price drop represented a market-capitalization loss of approximately $643 million. One of Inovio's directors was alleged to have engaged in directly related insider trading as well.

Side C Litigation

The following cases allege both Side C (entity coverage) and Side A wrongful acts. The focus in discussing these cases is primarily on the Side C allegations.

Douglas v. Norwegian Cruise Lines, Case No. 1:20-cv-21107 (filed in the U.S.D.C., S.D. Fla., on March 12, 2020), a class-action shareholder suit, alleges a violation of federal securities laws arising from Norwegian Cruise Lines' (NCL) misleading and materially false statements regarding COVID-19 in its 8-K and 10-K filings with the Securities and Exchange Commission (SEC) from February 20, 2020, through February 27, 2020. NCL and its directors and officers are named defendants. Specific allegations include false statements by NCL regarding its "positive outlook" for the company's business despite increasingly alarming news about the COVID-19 outbreak.

The plaintiffs further allege that NCL employed sales tactics that provided customers with unproven and/or blatantly false statements about COVID-19 so that customers would purchase cruises. In addition, plaintiffs allege that the company pressured its sales force to minimize the future threat of COVID-19 and to make false statements to potential customers in order to increase lackluster cruise reservations. These allegations were based on reporting by the *Miami New Times* on March 11, 2020.

On the day the *Miami New Times* piece was published, NCL's stock price dropped from $20.50 per share to $15.03—a 26.7 percent 1-day drop. The following day, *The Washington Post* published an article revealing additional allegations against NCL that company managers urged salespeople to "spread falsehoods about coronavirus," which included the statement that "coronavirus in humans is an overhyped pandemic scare." That same day, NCL's stock price dropped again. This time, the stock fell to close at $9.65—a 1-day drop of $5.38 or 35.8 percent.

The plaintiffs allege violations of Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 against both NCL and its directors. In addition, the plaintiffs allege violations of Section 20(a) of the Securities Exchange Act by NCL's directors and officers.

This lawsuit is a fairly typical stock drop suit that potentially triggers Side A D&O coverage for the NCL directors and officers named in the suit. The suit also raises allegations of company misconduct that likely trigger Side C (entity securities claim) coverage for NCL itself. Side C coverage for public companies is usually limited to liability arising from securities claims—claims brought by or on behalf of securities holders of the company or that arise from the sale of or the offer to purchase or sell securities issued by the company. Here, the plaintiffs assert that NCL publicly made false statements about the company's future business outlook and pressured its employees to lie to customers and potential customers. The plaintiffs allege that they paid too much for stock when it was trading at "inflated" prices as a result of NCL's false statements.

Another cruise-line D&O suit was filed against Carnival in *Service Lamp Corp. v. Carnival Corp.* (filed in the U.S.D.C., S.D. Fla., on May 27, 2020). In *Carnival,* shareholders allege Carnival made false statements about the presence of COVID-19–infected passengers and downplayed the extent to which various cruise ships were experiencing outbreaks. As with most such suits, the allegations center on public statements—primarily, through corporate public filings. As in *Douglas v. NCL,* the *Carnival* plaintiffs allege that these fraudulent and misleading statements caused the stock to trade at artificially high prices. The plaintiffs allege that they purchased stock at those higher "inflated" prices. When it was revealed that Carnival's ships had significant COVID-19 infections, the stock price fell $0.53 in mid-April 2020 and another $1.97 in early May.

Brams v. Zoom Video Comms., Inc., Case No. 3:20-cv-02396 (filed in the U.S.D.C., N.D. Cal., on April 8, 2020), a class-action suit, alleges violations of Section 10(b) of the Exchange Act and Rule 10b-5 by the company (Side C allegations) and individual defendants (Side A allegations). It also alleges a violation of Section 20(a) of the Exchange Act, which imposes vicarious liability for securities fraud

on controlling persons for the conduct of controlled actors with exceptions for good faith and lack of inducement of the controlled actor. The Section 20(a) allegations against the individual defendants would likely also fall under Side A D&O coverage.

The facts are alleged as follows. In March 2019, Zoom began the process of going public. This initial public offering (IPO) was completed on April 18, 2019. Zoom's IPO was successful—it sold 9,911,434 shares for $36.00 per share. The Zoom shareholder plaintiffs allege that Zoom made materially false and misleading statements from the beginning of its IPO when Zoom touted its "unique technology and infrastructure [that] enable best-in-class reliability." Its offering documents went on to state that Zoom "offers robust security capabilities, including end-to-end encryption, secure login, administrative controls and role-based access controls."

In July 2019, security researchers and public-interest groups started going public with concerns that Zoom was putting its users' privacy and security at risk. Zoom shares fell $1.32 per share on the heels of these publicly voiced concerns. Through the rest of 2019 and into early 2020, Zoom downplayed these risks and related legal proceedings before the Federal Trade Commission.

Throughout the first quarter of 2020 and into April 2020, governmental stay-at-home and shelter-in-place orders resulted in a surge in Zoom usage. Its share price followed suit. Zoom entered 2020 with a share price of approximately $68 per share. By March 23, 2020, its shares had climbed to $165 per share. With wider usage came more intense scrutiny of Zoom and its inaccurate statements about privacy and encryption protocols. National news media started featuring stories of, among other security and data-breach concerns, Zoom meetings being "Zoom-bombed" (i.e., uninvited attendees joining meetings and disrupting them) and users' data being hacked and shared without their permission and in direct conflict with company statements about protecting user data. Various companies—including SpaceX and NASA—banned employees from using the Zoom meeting app. Consumer class actions were filed against Zoom.

As a result, between March 27, 2020, and April 2, 2020, Zoom's share price fell $29.77 per share. More bad news and litigation followed. Zoom was forced to make public disclosures regarding its security flaws. By April 6, 2020, Zoom shares had dropped to $122.94 per share from a March 23, 2020, high of $165 per share. Adding to the bad optics, several Zoom executives sold substantial numbers of their company shares in mid-March. As in *NCL* and *Carnival,* Zoom's shareholders allege they paid inflated prices for Zoom stock because of the tardy disclosures about security flaws.

The Arbitrage Fund v. Forescout Techs., Inc., Case No. 3:20-cv-03819 (filed in the U.S.D.C., N.D. Cal., on June 10, 2020), involves the failed acquisition of Forescout by Advent Technologies and alleges failure to disclose by Forescout, its CFO, and the dual-hatted CEO/Board Member DeCesare when that deal began to unravel. Forescout, a computer and network security company, supposedly withheld disappointing fourth-quarter 2019 earnings news. In addition, Forescout was alleged to have inflated reported earnings through a one-off transaction with one of its largest resale customers. The gist of the shareholders' complaint is that Forescout knew as early as March 2020 that Advent had concerns regarding Forescout's finances and that, through April 2020, Forescout refused to provide updated financial information and projections to Advent. The plaintiffs alleged that Forescout's CFO and CEO/director "stood to receive over $42 million from the transaction with Advent."

During the negotiations, COVID-19 hit the Asia-Pacific region hard, which is where Forescout was experiencing "significant financial collapse." The plaintiffs allege that Forescout withheld this information and that Forescout knew there was a greater material risk that the Advent transaction would not

close. The plaintiffs allege that, by March 24, 2020, when Forescout issued its definitive proxy statement, the company knew COVID-19 was severely impacting its business and that Advent had started to express concerns about Forescout's financial performance. The deal fell apart on May 15, 2020, when Advent sent Forescout a letter stating that it would not be proceeding with the transaction on May 18, 2020.

Forescout's stock quickly fell from $29.52 per share to $22.57 per share. The stock declined further the next day to $19.85 per share. It was later revealed, in subsequent litigation Forescout brought against Advent over the failed transaction, that Advent's letter terminating the transaction cited both a material breach of various covenants by Forescout and that a company material adverse effect—a significant decline in Forescout's value—had occurred.

The shareholder claim against Forescout includes allegations that Forescout violated Exchange Act Section 10b, Rule 10b-5, and Exchange Act Section 20(a). Thus, like the Zoom litigation, plaintiffs' claims against the company and the individual defendants raise both Side A and Side C allegations.

Gelt Trading, Ltd. v. Co-Diagnostics Inc., Case No. 2:20-cv-00368 (filed in the U.S.D.C. of Utah on June 15, 2020), arises from an alleged "pump-and-dump" scheme in which the company and the company's officers and directors made false and misleading statements that Co-Diagnostics' COVID-19 test was 100 percent accurate. The stock price rose quickly after these public statements. The directors and officers exercised low-priced options at the height of the stock's trading price (during the "pump") and then sold ("dumped") their stock into the market before revelations of the falsity of these statements caused the stock to drop from an all-time high of $29.72 and a market capitalization of over $800 million to a low in the range of $15 to $16. These allegations raise potentially covered Side A and Side C claims.

Hartel v. The GEO Group, Inc., Case No. 9:20-cv-81063 (filed in the U.S.D.C. of S.D. Fla. on July 7, 2020), is another federal securities class-action (stock drop) suit asserting both Side A and Side C claims. In brief, the plaintiffs allege that, between February 27, 2020, and June 16, 2020, GEO Group, which designs, finances, and operates private prisons and halfway houses, made false and misleading statements about its COVID-19 response procedures. The shareholder-plaintiffs point to several specific instances, including GEO Group's 2019 10-K annual report and an earnings call on April 30, 2020, in which GEO Group failed to disclose "ineffective COVID-19 response procedures" and that the company was "vulnerable to significant financial and/or reputational harm." On the heels of a news story about a COVID-19 outbreak at one of its facilities, GEO Group's stock dropped from $13.20 to $12.17 on June 17, 2020.

Another D&O claim based directly on company representations regarding treatment or testing of COVID-19 patients is *Wasa Medical Holdings v. Sorrento Therapeutics, Inc.,* Case No. 3:20-cv-00966 (filed in the U.S.D.C., N.D. Ca., on May 26, 2020). On May 8, 2020, Sorrento issued a press release regarding a partnership with Mount Sinai hospital to develop antibody therapies to target and block COVID-19 infections. One week later, Sorrento announced it had discovered an antibody that "demonstrated 100% inhibition of [COVID-19] virus infection." News of the inaccuracies of these statements resulted in a significant drop in the trading price—from a high of $10 per share to a low of $5.07—in 7 days. The shareholder-plaintiffs allege that Sorrento's statements about the antibody were false, misleading, and made for the purpose of a pump-and-dump scheme.

Potential Coverage Issues Going Forward

Given that the negative economic impact of COVID-19 is expected to last some time, additional COVID-19–related Side A and Side C

suits are likely. Additional stock drop suits will likely be filed on the heels of disappointing earnings news from public companies. Overly optimistic statements from science/health/technology companies regarding treatment or diagnostics may also lead to more litigation. Side A suits alleging D&O fraud and self-dealing—sales of personally held stock on the eve of negative financials being made public—may increase.

Several potential coverage traps await D&O insureds. One depends on the timing of the company's D&O insurance renewal. Public companies can expect a push by insurers for COVID-19–specific exclusions to be included in new policies. Another risk is a possible broadening of the related-claims provisions in policies so that more claims and notices of potential claims fall within their scope. This would push any coverage for COVID-19–related claims into one policy period and its attendant policy limits. These concerns are especially relevant given the hard D&O insurance market that has taken shape simultaneously with the pandemic.

Public companies will almost certainly face increased pressure to disclose information about their COVID-19–related risks under applicable disclosure and reporting laws. Heightened corporate disclosure requirements bring with them a greater risk of securities-fraud litigation. Along with these disclosure requirements, if a company's D&O insurer finds that the policy application or renewal forms lacked sufficient candor, the company may find itself without coverage for COVID-19 D&O litigation should the insurer exercise its right to rescind coverage. In this case, any applicable severability provisions will be critical in determining if coverage is eliminated for all insureds or only the insureds that knew of the omissions or misleading statements in the policy applications.

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