RT ProExec
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TOP D&O STORIES FROM 2023

2023 was a particularly eventful year with important consequences for the D&O insurance marketplace. The past year's many developments also have significant implications for what may lie ahead in 2024 – and possibly for years to come. This edition of RT ProExec Insights discusses several risks that developed in 2023 and their potential implications.

The Number of Federal Court Securities Class Action Lawsuit Filings Increased in 2023

Securities class action lawsuits represent one of the most significant severity risks for public company D&O insurers. For that reason, the insurers closely track the annual number of securities class action lawsuit filings. The number of filings provides a significant indicator of the insurers' likely loss experience for the year, and the filings trends represent an important factor in insurers' calculation of their profit-making price. Accordingly, insurers will be concerned to note that the number of federal court securities class action lawsuit filings increased in 2023, after significant declines in more recent years from record-setting levels that prevailed during the period 2017-2019.

According to our tally, 213 federal court securities class action lawsuits were filed in 2023, compared to 197 in 2022, representing an increase of about 8%. The number of 2023 federal court securities class action lawsuit filings, while up compared to 2022, was well below the over 400 securities suit filings that were filed each year during the period 2017-2019. Please note that these figures include only federal court securities suit filings; the numbers do not include securities class action lawsuits filed in state court.

The number of annual federal court securities class action lawsuit filings was elevated during the period 2017-2019 by a flood of federal court merger objection class action lawsuits. However, the merger-related lawsuits were hardly a factor in the total number of federal court securities class action suit filings in 2023. By our count, there were only six federal court merger objection class action lawsuits filed in 2023. (Merger objection lawsuits were still being filed in significant numbers during 2023, but the lawsuits were filed as individual actions rather than as class actions, and so do not show up in the class action lawsuit filing tallies.)

The overall increase in the number of federal court securities class action lawsuit filings in 2023 was, in our view, driven by a number of factors.

As further discussed in the section below, there were a series of new lawsuits filed in 2023 related to the Banking Crisis of 2023; indeed, banks in general were a more frequent target in 2023. By our tally, there were twelve federal court securities class action lawsuits filed in 2023 against companies in the 602 SIC Code Industry Group (Commercial Banks). High interest rates caused many of the issues at the banks; as discussed in the third section below, high interest rates and other macroeconomic factors (including economic inflation and supply chain and labor supply disruption) were generally significant factors in the total number of securities suits filed overall in 2023.

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As has been the case in most recent years, there were significant numbers of federal court securities class action lawsuits filed in 2023 against companies in the biotech and high-tech sectors.

Thus, by our tally there were 25 securities class action lawsuits filed against companies in the 283 SIC Code Industry Group (Drugs), including 17 in the 2834 SIC Code category (Pharmaceutical Preparations). There were also an additional nine securities class action lawsuits filed against companies in the 384 SIC Code Industry Group (Surgical and Medical Instruments), bringing the total number of 2023 federal court securities class action lawsuit filings against companies in the biotech sector to 34, representing 16% of all securities suits filed during 2023.

With respect to the securities suit filings against high-tech companies, there were 29 federal court securities class action lawsuits filed in 2023 against companies in the 737 SIC Code Industrial Group (Computer Programming and Data Processing), including 17 in SIC Code Category 7372 (Prepackaged Software). The 29 securities suits against companies in the this SIC group represented about 13.6% of all of the federal court securities class action lawsuits filed in 2023.

The lawsuits filed against biotech and high-tech companies together represented a total of 66 suits, representing about 31% of all the 2023 federal court securities class action lawsuit filings.

The increase in securities suit filings in 2023 comes at a time when D&O insurance pricing is under significant pressure, one of several factors complicating the current D&O insurance marketplace.

The Banking Sector Has a Tumultuous Year

Over the course of several weeks from March to early May in 2023, three large U.S. banks failed in a sequence of events that has come to be known as the Banking Crisis of 2023. The failed banks' $548.7 billion in combined asset value represents the highest amount for failed banks in a single year, ever.

Fears arose at the time that the bank failures could trigger a contagion event across the banking industry. However, the Fed, the Treasury Department, and the FDIC acted forcefully and took extraordinary measures to reassure markets and depositors of the safety and security of the banking system. These measures were sufficiently effective that within a very short time calm returned to the banking sector and there were no further large bank failures during the year.

But while the aggressive regulatory action may have helped the banking industry to dodge a contagion event, it did not necessarily remedy the underlying concerns for many banks.

In recognition of the continuing concerns, on August 7, 2023, the ratings firm Moody's took credit rating action on 27 banks, including downgrading the credit ratings of ten banks, putting others under review, or giving their ratings a negative outlook. The reasons for the firm's actions included rising deposit costs and risks to commercial property and construction loans posed by changes to the commercial real estate market brought about by shifts to remote work during the pandemic. On August 21, 2023, S&P also took actions similar to those of Moody's, downgrading or cutting the ratings on a host of banks, for similar reasons.

The way that the concerns the credit rating agencies cited can lead to securities litigation, even in the absence of a bank failure, is illustrated in at least two banking crisis-related securities suits filed later in 2023.

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First, on August 4, 2023, a plaintiff shareholder filed a securities class action lawsuit in the Northern District of Ohio against KeyCorp, the bank holding company for KeyBank, and certain of its executives. The plaintiff shareholder filed the lawsuit in the wake of declines in Key's share price after bank executives announced reductions in the company's earnings guidance, as the bank found itself required to pay higher interest rates to attract deposits. The complaint also referred to the bank's disclosures about liquidity issues.

Second, on September 11, 2023, a plaintiff shareholder filed a securities class action lawsuit in the Central District of California against PacWest and certain of its directors and officers. In July 2023, PacWest had announced its plan to merge with the Bank of California. PacWest struggled with many of the same issues that had taken down Silicon Valley Bank, including large unrealized losses in its bond portfolio and significant amounts of uninsured deposits. The securities complaint alleges that the defendants made misrepresentations in connection with the events surrounding the other banks' failures and leading up to the July merger.

The worries about commercial real estate that the rating agencies noted may represent a reason to continue to be concerned about the banking sector. As the Wall Street Journal has detailed, rising vacancy rates in office buildings has stressed the commercial real estate sector, putting many landlords in a difficult spot as they continue to try to service their debt. The well-publicized sector stress has put many borrowers in a position where they cannot roll over their debt as existing loans mature. The increased vacancy rate and the drying up of lending capacity increases the likelihood of commercial real estate loan defaults.

The net result is what the Wall Street Journal has called a "doom loop" that, according to the Journal, "threatens America's banks." The "doom loop" scenario involves the following stages: "losses on the loans trigger banks to cut lending, which leads to further drops in property prices and yet more losses." How all this will play out remains to be seen, but the process won't play out quickly; rather, it will, according to the Journal, be a "slow grind." 2023 was difficult for commercial landlords; according to the Journal, 2024 will be worse. All of this is bad news for commercial landlords, and for their lenders.

Another problem for many banks, particularly smaller banks, is the value of the securities they hold on their balance sheets. After federal government stimulus money flooded many banks with deposits during the pandemic, some banks invested in interest-rate sensitive securities, particularly long-dated bonds. As the Fed raised interest rates starting in March 2022, and raised rates higher and faster than many banks anticipated, the banks saw the market value of their bond portfolios plummet, putting some banks' balance sheets "underwater." As the Wall Street Journal put it in a December 28, 2023 article, many community banks have been in a "full blown crisis"; according to the Journal, more than 300 U.S. banks have half or more of their assets in securities, and about 100 of these banks have more than 75% in securities.

The bottom line is that it may be too early to sound the "all clear" signal for the banking sector. There could still be more of the story to be told in the months ahead.

Macroeconomic Factors Weigh on Businesses and, in Some Cases, Translate into Securities Suits

One significant factor in the huge bank failures in 2023 was the impact of elevated interest rates, as discussed above. But high interest rates were only one of several macroeconomic factors affecting the overall business environment in 2023. Other significant macroeconomic factors included rising economic inflation, and labor supply and supply chain disruption. These factors not only presented companies with business challenges; in many cases, the impact of these factors on company operations translated into securities class action litigation.

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Thus, for example, in March 2023, the coffee-shop chain Dutch Bros was hit with a securities class action lawsuit after the company announced disappointing financial results due to inflationary pressure on the company's margins. Similarly, and also in March 2023, the organic food company United Natural Foods was sued in a securities suit after the company disclosed a profitability decline, despite increased sales, due to inflationary pressure. The backup power supply company Generac Holdings was sued in a securities class action lawsuit in November 2023 after the company announced decreased sales due to declining consumer demand because of elevated interest rates.

Labor supply and supply chain issues led to securities lawsuits in other cases. Thus, for example, in January 2023, the chain eye care firm National Vision was sued in a securities lawsuit after the company announced disappointing financial results the company blamed on its difficulties in recruiting and retaining professional staff after the pandemic. In April 2023, the hydrogen fuel cell company Plug Power was hit with a securities suit after the company announced disappointing revenue growth due to supply chain "complexity." In July 2023, the drug company Baxter International was sued in a securities lawsuit after the company announced that continuing supply chain issues were setting back its operations.

In yet another lawsuit during the year in which macroeconomic factors played an important role, in November 2023 investors filed a securities class action lawsuit against the software company Expensify. The shareholder plaintiff alleged not that a single macroeconomic factor undercut the company's results, but rather that adverse macroeconomic conditions in general – what the plaintiff's complaint called "macroeconomic headwinds" — hurt the company's financial results and caused it to fall short of the growth projections it made in its IPO.

As challenging as the economic circumstances were in 2023, things could have been worse. At the outset of the year, a majority of economists surveyed were predicting that the U.S. would enter a recession during 2023. Fortunately, the country managed to avoid falling into a recession during the year; some hope that perhaps the U.S. has managed to pull off the almost mythical "soft landing."

The extent to which the challenging economic circumstances will continue to weigh on the economy as we head into 2024 of course remains to be seen. Much will depend on what happens with interest rates. At its final meeting for the year in December 2023, the Federal Reserve not only held interest rates steady, but signaled that it was ready to pivot its interest rate approach in 2024. Though his remarks following the meeting were guarded and cautious, Federal Reserve Jerome Powell (and accompanying documentation) suggested that Fed officials anticipate as many as three rate cuts in 2024.

The reasons the Fed has shifted on its interest rate policy signaling is also good news; inflation appears to have eased significantly in recent months – although it still remains above the Fed's target rate. Labor supply issues and supply chain issues appear to be continuing to improve as the economy recovers from the pandemic-related shutdowns.

The possibility for interest rate easing represents a positive sign for the economy and for economic prospects in the new year. Were macroeconomic challenges to ease, it could reduce at least one source that presented significant securities litigation risk in 2023.

Geopolitical Risk Contributes to Corporate Litigation Exposures

In addition to the macroeconomic factors discussed above, an additional consideration complicated the global business environment and also heightened corporate and securities litigation risk during 2023. As discussed below, a variety of issues contributed to geopolitical risks during the year; a host of additional issues that could come into play in the months ahead could make geopolitical risk an even bigger factor in 2024.

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For starters, several securities lawsuits filed in 2023 underscored the political challenges associated with doing business in China. For example, in June 2023, the China-based video company DouYu International Holding Limited, whose securities trade on Nasdaq, was hit with a securities lawsuit after Chinese government crackdown on video game and computer addiction resulted in Chinese regulatory enforcement action against the company.

Similarly, Futu Holdings Limited, a Hong-Kong based digital financial services company with securities trading on Nasdaq and that was providing services to consumers in China, was also sued in a securities class action lawsuit after it was subject to a regulatory crackdown based on questions surrounding its licensure to provide the financial services to Chinese consumers.

Questions concerning international trade regulations and trade sanctions also led to securities lawsuits during the year. For example, in July 2023, the computer memory device company Seagate Technology Holdings was sued in a securities lawsuit after a Department of Commerce division imposed a $300 million penalty against the company for violation of export restrictions related to the Chinese company, Huawei. In November 2023, the directors and officers of the bankrupt medical device company Rockley Photonics Holdings were sued in a securities suit after the company lost revenue from a joint venture partnership when the venture partner was added to the U.S. Department of Commerce's export restrictions entities' list.

The list of geopolitical risk-related securities lawsuits filed in 2023 may appear to be relatively short. However, there is no doubt that as we head into 2024, the world is in a very dangerous geopolitical environment. There are not only two hot wars being fought, each of which has a dangerous and worrisome potential to spread, but there are tensions in the South China Sea with further worrisome potential, as well as ongoing trade tensions between the U.S. and China.

There are a host of other sources of geopolitical stress that could lead to business and operating difficulties for many companies. To focus on just one topic heading, there are a number of elections scheduled or likely to be scheduled in 2024 that could significantly affect the geopolitical environment. The U.S. Presidential election scheduled for 2024 could have (and seems likely to have) enormous geopolitical implications. But the U.S. is not the only country with a Presidential election scheduled this year – Mexico and South Africa also will have elections in 2024. Elections are also likely in Canada, the U.K., and India. In all, more than two billion people in roughly 50 countries representing over 60% of global GDP will go to the polls in 2024.

We believe geopolitical risk may create significant operating and business challenges for many companies and, in many cases, these challenges will translate into corporate and securities litigation.

Regulatory and Legislative Actions Ensure That ESG Remains a Hot Button Issue

One of the hot button topics for several years has been "ESG" – which is an acronym representing a grab bag of Environmental, Social, and Governance concerns. In recent years, many companies have felt pressured by institutional investors and other constituencies to show that they are "good" on ESG (even though there is no consensus on what it actually means to be "good" on ESG).

More recently, as the issues surrounding ESG have evolved, companies have found themselves under very different kinds of scrutiny. As pressure from activists at other points on the political spectrum has developed, an ESG backlash has emerged, resulting in political and legislative action in some conservative states, and in litigation in other instances as well. Companies themselves increasingly trying to avoid the cross-fire, as a result of which

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increasing numbers of companies are resorting to "greenhushing" – that is, taking a much lower profile on ESG-related concerns. For these and for a variety of other reasons, there have been public calls from academics and others to the effect that it may be time to "say RIP to ESG."

While some commentators may be done with ESG, the fact is that ESG is not done with us. Pending and existing regulatory changes ensure that ESG will continue to be a high-profile issue for corporate executives, regulators, investors, and others, for some time to come.

Among the pending regulatory concerns is the long-awaited final release of the SEC's final climate change disclosure guidelines. The agency first released the draft guidelines for public comment in March 2022. The release of the final rules has been delayed multiple times. It now appears that the agency will not release the final climate change disclosure guidelines until at least April 2024, at the earliest. Although it still remains to be seen what will be in the final guidelines, at this point it must be assumed, based on the draft release, that final rules will impose significant disclosure requirements on reporting companies concerning greenhouse gas emissions and climate change-related risk management.

While we continue to await the SEC's final guidelines, other regulators and other authorities have moved forward. Among other things, both the EU and the California legislation have put in place extensive climate change and ESG-related guidelines that will affect many companies, including those outside the EU and California.

First, On July 31, 2023, the European Commission adopted the first set of European Sustainability Reporting Standards (ESRS), which require EU and non-EU companies with specified levels of EU activity to file annual sustainability reports with their financial statements. The standards will soon become law and apply in all 27 EU Member states, with compliance requirements effective as early as 2025 for the 2024 reporting period. The ESRS set out detailed reporting requirements for EU companies, including general reporting requirements; a list of mandatory disclosure requirements related to the identification and governance of sustainability matters; and ten ESG-related topics on which disclosure is required, subject to a materiality assessment.

The standards adopted in the first ESRS go considerably further than the disclosure requirements in the SEC's proposed climate change disclosure guidelines; among other things, the EU standards require companies to report on a broader set of sustainability topics, such as biodiversity, water, and pollution. The EU standards also apply to private companies.

Of critical importance, for the fiscal year 2028 (that is, to be reported in 2029), non-EU companies that generate a net turnover of more than 150 million euros in the EU in the last two consecutive financial years must comply with the reporting standards. Similarly for the fiscal year 2028, non-EU companies that have at least one subsidiary or branch within the EU must comply with the reporting requirements. In other words, the EU disclosure requirements could — and are intended to – have a huge impact on companies based outside the EU.

As if that were not enough, in September 2023, the California legislature adopted two pieces of legislation, subsequently signed into law by the California governor, that will similarly impose significant disclosure obligations on a host of companies, including even those not based in California.

Senate Bill 253, signed into law on October 7, 2023, requires Scopes 1,2, and 3 greenhouse gas (GHG) emissions disclosures from all business entities "doing business" in California with revenues greater than $1 billion. The disclosure requirements in effect require companies to make disclosures concerning GHG both up and down the companies' value

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chains. The annual GHG disclosures are to commence in 2026 with respect to Scopes 1 and 2; disclosures with respect to Scope 3 emissions commence in 2027.

Senate Bill 267, also signed into law on October 7, 2023, requires that on or before January 1, 2026, and every two years thereafter a “covered entity” must disclose its “climate-related financial risk” and measures taken to reduce and adapt to climate risk. A “covered entity” is a business with over $500 million in revenue and that does business in California.

The California legislature estimated that SB 253 will affect as many as 5,300 companies, and SB 267 will affect as many as 10,000 companies. The two bills are almost certain to face legal challenge; among other obvious concerns is that neither of the two bills defines what it means to be “doing business” in California.

Among the many risks with the various disclosure requirements is the possibility that the new guidelines could increase the potential shareholder litigation exposure for publicly traded companies. Companies that make optimistic claims about their emissions efforts or the sustainability of their operations could be subject to “greenwashing”-type claims. Companies that experience operating setbacks or diminished financial results because of climate impacts (as for example companies experience extreme weather events or of changed climate conditions) will have their prior disclosures closely scrutinized.

Even though the new guidelines have not yet taken effect, and the SEC’s final guidelines have not even yet been released, the new and anticipated disclosure requirements represent a significant challenge for many companies. The bottom line is that, regardless of what some observers may want, ESG is going to remain a hot-button issue for a long time to come.

Closing Comments

There were many more developments in 2023 that may have significant implications for the D&O marketplace in 2024, such as:

1. Cybersecurity claims related to the new SEC disclosure guidelines
2. The new corporate risk of artificial intelligence

We welcome the opportunity to discuss any of the above items with you in further detail.

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