News & Views

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LEGAL NEWS AND DEVELOPMENTS IN EXECUTIVE, EMPLOYMENT, CRIME, AND CYBER LIABILITY

APPRAISAL ACTIONS ARE 'SECURITIES CLAIMS' UNDER D&O POLICIES

For many corporate insureds, the D&O insurance market's failure to acknowledge coverage for dissenting shareholders' appraisal actions has been a source of contention for several years. Thanks to the Delaware Superior Court's recent ruling of first impression in *Solera Holdings, Inc. v. XL Spec. Ins. Co.*, companies may now be afforded increased protection under their D&O policies.

WHAT YOU SHOULD KNOW

Historically, insurers have taken the position that appraisal actions do not allege a"Wrongful Act," generally defined in D&O policies as a violation of federal, state or local statute, regulation or rule or common law regulating securities, and do not, therefore, qualify as "Securities Claims."

As entity coverage is available under a public D&O policy only for "Securities Claims," insurers routinely deny coverage in its entirety for appraisal actions, or in some "squeaky wheel" instances, may afford limited coverage for a percentage of defense costs.

The *Solera* ruling confirms what many in the brokerage community have maintained for years: appraisal actions should be covered under D&O policies. Nevertheless, celebration of this ruling may be short-lived as D&O insurers will likely seek to revise future policy language, possibly leading to an exclusion for appraisal actions, revisions to the definition of "Loss," and/or a higher premium for appraisal action coverage.

Some insureds may prefer that appraisal actions NOT be covered as such matters will invariably be entity issues and dilute traditional D&O insurance limits otherwise available to individual insureds. For insureds that do want D&O coverage for appraisal actions, we recommend that coverage be specifically clarified with underwriters.

In the meantime, if your company's shareholders file an appraisal action, consider immediately notifying your D&O insurers.

IN THIS ISSUE

THE COURT'S RULING

The coverage dispute at issue in *Solera* arose following a private company's acquisition of Solera and the ensuing Delaware appraisal action in which Solera's shareholders sought a judicial determination of the fair value of their shares. At trial, the court determined the fair value was actually less than the merger price and ordered the company to pay the shareholders the lesser amount, plus $38.3 million in prejudgment interest. Solera sought coverage from its D&O insurers for the prejudgment interest and $13 million in defense expenses.

The D&O insurers denied coverage, however, claiming the appraisal action was not a "Securities Claim" as it did not allege "Wrongful Acts," and the prejudgment interest did not constitute "Loss" because the underlying fair value award was not covered. In response to the denial, Solera filed suit against its D&O insurers, arguing the appraisal action did, in fact, allege a "Wrongful Act," specifically an alleged violation of the statute requiring payment of fair value to shareholders for their shares.

The court agreed, declaring the policy unambiguously provided coverage for alleged violations of a law or rule regulating securities, and the common meaning of the word "violation" is not limited to wrongdoing. According to the court, a violation is "a breach of the law and the contravention of a right or duty," and "[b]y its very nature, a demand for appraisal is an allegation that the company contravened that right by not paying shareholders the fairvalue to which they are entitled."

Regarding prejudgment interest, the court disagreed with the insurer's argument that prejudgment interest is only covered when ordered in conjunction with a covered judgment, stating the insurer's argument was "untethered to the language in the policy." The policy's definition of "Loss," the court found, clearly included "damages, judgments, settlements, prejudgment and post-judgment interest or other amounts … that [the insured] is legally obligated to pay." The insurers immediately appealed to the Delaware Supreme Court.

CAC Specialty will continue to monitor this case for further developments.

NO COVERAGE FOR CLASS ACTION ALLEGING 'RELATED WRONGFUL ACTS'

Often used as a sword *and* a shield by insurers, the interrelated wrongful acts provision in liability policies has been the subject of countless coverage disputes. Courts often have a difficult time dissecting these broad provisions, and thus the resultant case law is all over the map. A court's analysis of each dispute necessarily focuses on the specific policy language, unique facts of the case, and jurisdictional case law.

THE KEY TAKEAWAY

The takeaway of this recent ruling is that claim reporting can be tricky when two policy periods are potentially at play, particularly when prior notice exclusions are involved. When questions arise regarding the interrelationship of claims, CAC Specialty's Legal and Claims Practice can provide guidance and support to ensure proper reporting and avoid unintended exclusionary consequences.

THE COURT'S RULING

In Navigators Spec. Ins. Co. v. Double Down Interactive, LLC, a Washington federal court recently tackled yet another coverage dispute involving the interrelationship of claims.

The underlying facts of the case involved a suit against the operator of an online casino game for unjust enrichment and violations of gambling and consumer protection laws.

The operator sought coverage under its D&O runoff policy, but the insurer denied coverage, finding the action was related to an earlier lawsuit that predated the inception of its policy. The policy defined "Related Wrongful Acts" as "Wrongful Acts which are logically or causally connected by reason of any common fact, circumstance, situation, transaction, event or decision." Arguing the two lawsuits were unrelated because they involved different plaintiffs, losses, claims, and state laws, the insured asserted that if the court were to find these two claims to be related, it would effectively eliminate insurance coverage for its entire business model.

Citing the broad nature of the definition of "Related Wrongful Acts," the court determined the "facts that arose to each complaint were nearly indistinguishable and the complaints themselves [were] facially identical in many areas," adding that several entire portions of the second complaint were copied directly from the earlier complaint.

Consequently, the court ruled in favor of the insurer, holding that the two lawsuits were interrelated and thus a single claim first made before the inception of the policy at issue.

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D&O POLICY'S BANKRUPTCY EXCLUSION IS A PROHIBITED *IPSO FACTO* CLAUSE

WHAT YOU SHOULD KNOW

In a recent court decision in which a post-petition insurance policy was found to be an executory contract to which *ipso facto* provisions applied, the D&O insurer likely never contemplated that a policy exclusion, particularly one that was almost certainly factored into the underwriting process and policy premium, may effectively be voided by the Bankruptcy Code. As a result, we expect carriers will proceed with more caution when underwriting distressed companies, making it even harder for such companies to obtain coverage at a time when they need it the most.

CAC'S SPECIAL SITUATIONS GROUP

CAC Specialty's Special Situations Group is unique in the insurance industry. Comprised of restructuring professionals who focus solely on insurance solutions for distressed and bankrupt companies, the Special Situations Group is skilled in addressing carrier concerns regarding distressed companies and negotiating innovative solutions that avoid these exclusions altogether.

THE COURT'S RULING

While winding down operations after filing for bankruptcy, an insured hospital negotiated a three-year tail policy with its D&O insurer. The trust to which the insured's rights had been assigned subsequently filed suit against the insured's former directors and officers alleging a breach of fiduciary duty and negligence.

The insurer denied coverage, citing the policy's bankruptcy exclusion, which precluded coverage for any claims "alleging, arising out of, based upon, attributable to, or in any way involving, directly or indirectly: (i) any Wrongful Act which is alleged to have led to or caused, directly or indirectly,wholly or in part, the bankruptcy or insolvency of the Organization[.]" In *CMH Liquidating Trust v. Nat. Union Fire Ins. Co. of Pittsburgh, PA*, the trust filed suit against the insurer, seeking the court's determination that the exclusion was an unenforceable *ipso facto* clause, described by the court as "a provision in an executory contract that provides for termination or modification based on the filing of a bankruptcy petition or the financial condition of the debtor," which is prohibited

under the Bankruptcy Code. The bankruptcy court held the exclusion was not a prohibited *ipso facto* clause because it did not purport to make the entire policy ineffective as a result of the bankruptcy filing. On appeal, the district court agreed with the trust's objection, finding the *ipso facto* prohibition may be triggered even if the challenged prohibition invalidates only part of a contract, and not the entire contract. However, the district court did not rule on the enforceability of the provision as the bankruptcy court needed to first determine whether the insurance policy was an "executory contract." On remand, the bankruptcy court found the policy was indeed an "executory contract" to which protection against *ipso facto* provisions applied. The insurer contended "the tail coverage did not exist pre-petition" and could not, therefore, "constitute an executory contract against which *ipso facto* provisions are unenforceable." In response, the trust asked the court to review the contractual relationship between the parties to establish whether the tail coverage "was continuous and essentially unchanged from the pre-petition period through the post-petition period, such that the same contractual relationship and the same contract can and should be deemed to have been extant pre-petition." The court found in favor of the trust, holding that the insurer's coverage denial "impeded an executory contract" to which the *ipso facto* prohibition applied.

CAC Specialty will continue to monitor and report on the D&O market's reaction to this ruling.

FIFTH CIRCUIT RULES SECURITIES EXCLUSION BARS COVERAGE FOR SELLERS' ALLEGED MISREPRESENTATIONS

In order to avoid costly litigation such as the case described below, CAC Specialty's Financial Lines Practice, along with its Legal and Claims Practice, works closely with clients to obtain more favorable language than that offered in insurers' off-the-shelf policy forms, including a narrower preamble and securities definition (i.e., publicly-traded securities).

THE COURT'S RULING

After the president and vice president of an ice cream company sold their equity interests in the company, the purchaser filed a lawsuit against the two alleging they misrepresented the company's financial condition before the sale. The insured individuals submitted the claim to the company's D&O insurer, which refused to provide a defense or indemnity, based on an exclusion in the policy barring coverage for "any Claim made against any Insured … based upon, arising out of or in any way involving … the actual, alleged, or attempted purchase or sale, or offer or solicitation of an offer to purchase or sell, any debt or equity securities."

In *Gleason v. Markel Am. Ins. Co.*, the insureds sued the carrier, arguing the transaction at issue was exempt from registration under Section 4(a)(2) of the Securities Act of 1933 as a "transaction[ ] by an issuer not involving any public offering." The district court disagreed, finding the policy exclusion applied because the insureds were not issuers."

The insureds petitioned the court to reconsider, arguing that if they were not issuers, the transaction should be considered a private placement transaction, and thus exempt from registration under Section 4(a)(1). In response, the district court denied the insureds' motion for reconsideration, stating they "never explicitly cited 15 U.S.C. § 77d(a)(1) as the provision [they] relied upon, never referenced this as Section 4(a)(1), never cited any case law, and did not provide a definition of 'underwriter' or 'dealer.'" Consequently, the district court ruled in favor of the insurer, and its ruling was recently affirmed by the Fifth Circuit.

D&O COVERAGE PRECLUDED BY HEALTHCARE EXCLUSION AND RELATED WRONGFUL ACTS

WHAT YOU SHOULD KNOW

Almost all private D&O policies include an exclusion for the insured's professional services (as this is an E&O exposure), but the breadth of these exclusions varies by policy. The exclusion at issue in the case described below was extremely broad, using absolute exclusionary wording and encompassing all claims by any party (in this case, a health insurance company to which no professional services were provided). CAC's Financial Lines Practice seeks to limit or remove such exclusions wherever possible to avoid this type of costly coverage litigation.

THE COURT'S RULING

A healthcare organization was sued by a health insurance company for violations of the Racketeer Influenced and Corrupt Organizations Act (RICO), common law fraud, negligent misrepresentation, unjust enrichment, civil conspiracy, tortious interference, and equitable accounting. Specifically, the organization was accused of creating "an extensive health care billing fraud scheme through which they bilked [the insurance company], employers that sponsor health plans, and [the insurance company's] members out of more than $21 million."

The insured healthcare organization submitted notice of the claim to its private D&O insurer, which discovered the existence of an earlier lawsuit against the insured involving the same set of defendants and same alleged fraudulent billing scheme. The earlier lawsuit, filed just months before, predated the inception of the insurer's policy, resulting in a declination of coverage based on the policy's exclusion of claims "arising from, based upon, or attributable to any … Wrongful Act specified in [a] prior demand, suit or proceeding or any Interrelated Wrongful Acts thereof."

The insured argued the insurer waived its policy provisions when it failed to uncover the first lawsuit during its underwriting process, and thus waived its right to enforce policy provisions to deny coverage for new claims related to such lawsuit. The court sided with the insurer, noting that "contract provisions cannot be waived before a contract is in force," and "it is perfectly sensible that a potential insurer would not worry about documenting claims that would clearly fall outside the scope of its coverage."

> *… "the policy need not provide coverage against all possible liabilities; if it provides coverage against some, the policy is not illusory."*

The insurer also relied on an exclusion for all claims "arising from, based upon, or attributable to … all healthcare and related services, including, without limitation, any … (b) laboratory, imaging and diagnostic services; (c) billing for services rendered or products provided; or (d) advice given in connection with any of the above." The insured argued that its insurer's interpretation of the lawsuit would render coverage illusory; however, the court noted "the policy need not provide coverage against all possible liabilities; if it provides coverage against some, the policy is not illusory."

The insurer asserted, as an example, that there would be coverage "if an insured is alleged to have breached its fiduciary duty to the company." While the insurer's example rings true for certain claims against individual insureds, it's difficult to imagine any claim against the organization itself that wouldn't arise from or be based upon or attributable in some fashion to "all healthcare and related services."

DELAWARE SUPREME COURT REVERSES COURT OF CHANCERY'S DUTY OF LOYALTY DECISION UNDER *CAREMARK*

WHY IS THIS IMPORTANT?

Compliance continues to be a hot topic for directors and executives alike, particularly in the cybersecurity and privacy liability space. In *Marchand v. Barnhill*, the Delaware Supreme Court recently reversed the dismissal of a claim that the directors of a large U.S. ice cream manufacturer breached their duty of loyalty, in which the Delaware Chancery Court's decision in *In re Caremark* was at the forefront.

Importantly, *Marchand* provides a roadmap for shareholders to survive a motion to dismiss under *Caremark*, along with a critical reminder to directors to "make a good faith effort to implement an oversight system and then monitor it." And, because the board's actions will later be viewed with hindsight, this case highlights the need to have a clear process in place to later demonstrate the board's actual exercise of good business judgment.

THE *CAREMARK* RULING

As background, the court in *Caremark* held that directors of Delaware corporations may be held liable for breaches of loyalty if they fail to implement and oversee the corporation's information systems and controls, even if exculpated from liability for breach of the duty of care. The Delaware Supreme Court later clarified in *Stone v. Ritter* that a *Caremark* claim can only be sustained if directors "knew that they were not discharging their fiduciary obligations," and it can be demonstrated that "(a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations."

THE *MARCHAND* RULING

The ice cream manufacturer at issue in *Marchand* suffered a listeria outbreak that resulted in a recall of all products, plant shutdowns, mass layoffs, and three consumer deaths. The company's stockholders also suffered losses due to the operational shutdown and liquidity crisis that forced the company to accept a dilutive private equity investment.

Derivative litigation ensued against the company's directors, wherein a shareholder alleged breaches of fiduciary duties and the directors' duty of loyalty under *Caremark*.

Additionally, two key executives, the CEO and VP of Operations, were accused of breaching their duties of care and loyalty by knowingly disregarding contamination risks and failing to oversee the safety of the company's food-making operations.

The directors successfully sought dismissal of the case for failure to plead demand futility, and with respect to the *Caremark* standard, the Court of Chancery found the shareholder "failed to plead particularized facts that raise a reasonable doubt as to whether a majority of [the company's] Board could impartially consider a demand."

The Court of Chancery held that while the complaint alleged facts sufficient to raise a reasonable doubt regarding the impartiality of the company's directors, the shareholder needed to demonstrate partiality of eight directors for a majority and only had seven.

In connection with the *Caremark*-related allegation, the Court of Chancery found the shareholder did not plead any facts to support "his contention that [the

company's board] 'utterly' failed to adopt or implement any reporting and compliance systems." In response to the shareholder's argument that the board had no supervisory structure in place to oversee "health, safety and sanitation controls and compliance," the Court of Chancery rationalized that "[w]hat [the shareholder] really attempts to challenge is not the existence of monitoring and reporting controls, but the effectiveness of monitoring and reporting controls in particular instances," and "[t]his is not a valid theory under ... *Caremark*."

> *... "what [the shareholder] really attempts to challenge is not the existence of monitoring and reporting controls, but the effectiveness of monitoring and reporting controls in particular instances," and "[t]his is not a valid theory under ... Caremark."*

The shareholder appealed to the Delaware Supreme Court, which reversed the Court of Chancery's ruling on both findings. First, the court found the facts sufficiently created a reasonable doubt that an additional director could act impartially in deciding to sue the executives due to his longstanding business and personal relationship with the CEO's family, noting the allegations were "suggestive of the type of very close personal [or professional] relationship that, like family ties, one would expect to heavily influence a human's ability to exercise impartial judgment."

In considering the *Caremark* claim, the Delaware Supreme Court suggested the facts "support a reasonable inference that the [company's] board failed to implement any system to monitor [the company's] food safety performance or compliance,"adding that "a director must make a good faith effort to oversee the company's operations." Consequently, the case was remanded back to the Court of Chancery for further proceedings.

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