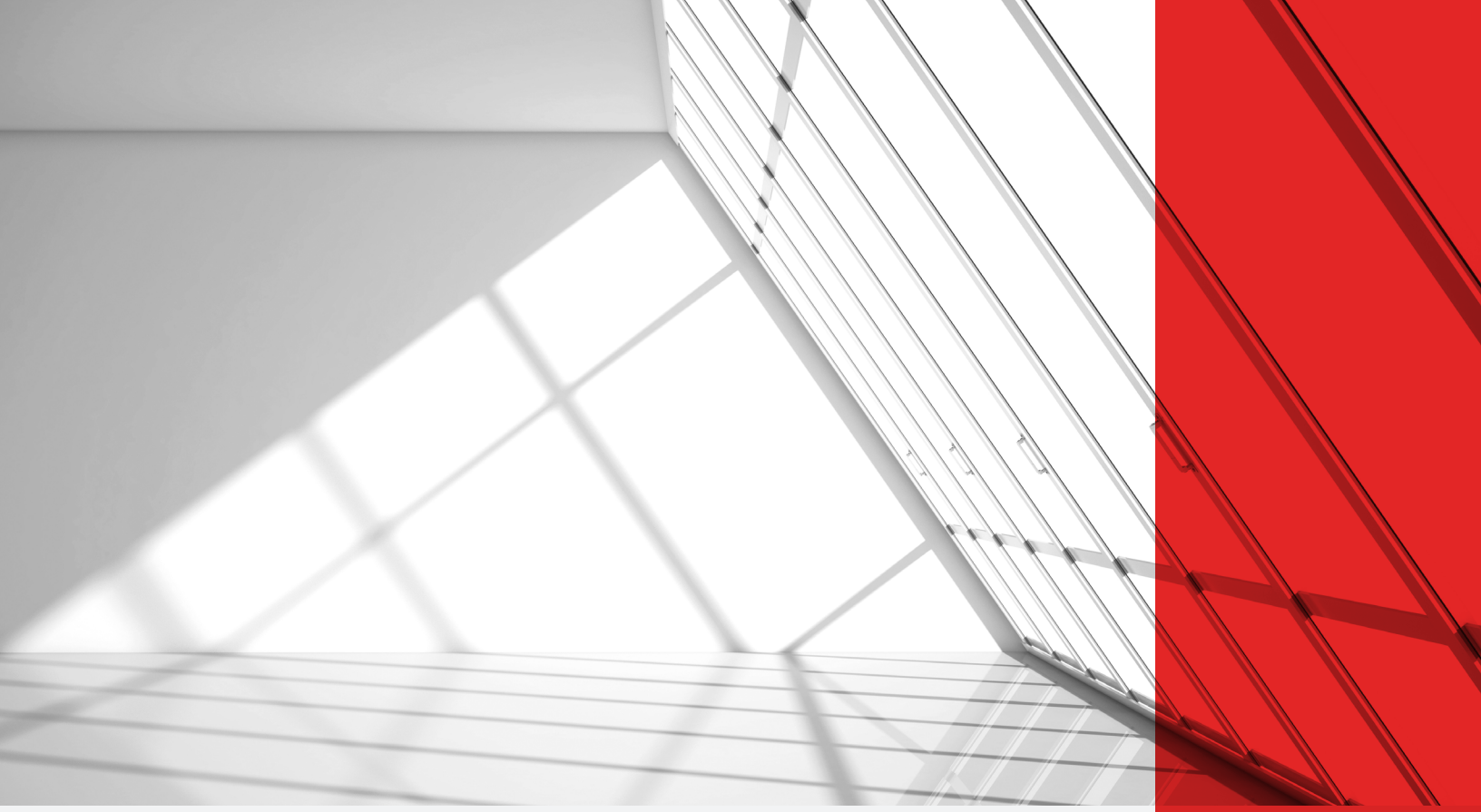

CAC Specialty™

UNINSURABILITY DEFENSE

TWO RECENT DELAWARE COURT RULINGS IN D&O INSURANCE COVERAGE CASES ARE WINS FOR POLICYHOLDERS

A recurring management liability coverage issue where policies do not expressly exclude disgorgement and restitution from covered "Loss" is whether disgorgement or restitution for alleged fraudulent conduct is otherwise uninsurable as a matter of law and/or public policy (the so-called "Uninsurability Defense"). A sometimes-related issue is the appropriate allocation for covered and uncovered matters and entities involved in claims. The answer to these questions, at least in Delaware, occurred in two recent cases where it was determined that these types of claims are insurable and that under the "larger settlement rule," an allocation is only appropriate when an insurer can demonstrate that a portion of a settlement is the result of uninsured acts or parties that increased the ultimate settlement amount of the case.

SYCAMORE PARTNERS V. ENDURANCE AMERICAN INSURANCE COMPANY, ET AL.

The first coverage decision, *Sycamore Partners v. Endurance American Insurance Company, et al.*, was issued on February 26, 2021 by the Delaware Superior Court. The underlying case arose out of an adversary proceeding filed as part of Nine West's bankruptcy, which followed Sycamore's leveraged buyout of the fashion retailer.

Specifically, Nine West's bankruptcy estate alleged that certain Sycamore funds and fund managers improperly raided Nine West's high-performing assets via a series of affiliated fraudulent transfers and left the remaining assets subject to insolvency and eventual bankruptcy. Sycamore's D&O insurance tower denied coverage for the $120 million settlement on the grounds that indemnity for the claim was uninsurable because the settlement constituted disgorgement and/or restitution for a fraudulent gain.

In what was ultimately an outcome determinative part of the ruling, and potentially why Sycamore initially moved to quickly file the coverage action in Delaware even before the underlying settlement was finalized, the court held that the law of Sycamore's incorporation, Delaware, controlled rather than New York. The insurers argued that New York law, which generally disfavors insurability for disgorgement and restitution, should have applied because it is the location where Sycamore is headquartered, the policies were brokered, the alleged wrongful acts took place, and Nine West's bankruptcy petition was filed. However, it should be noted that New York case law on this issue remains a mixed bag with the outcome far from certain even if the coverage action had been decided by a New York court and/or another court applying New York law.

However, the Sycamore decision reaffirmed that in order for a public policy against insurability to be enforceable in Delaware, it must be contained in a statute, not merely in a court decision. As there is no Delaware statute (or case law) forbidding insurability of disgorgement or restitution and because the Sycamore fund managers' personal profit and/or intentional acts were not established in a final, non-appealable adjudication as required by the subject policy, **the $120 million settlement was insurable under Delaware law**.

> **The court's decision clearly reinforces Delaware's view that absent a clear choice of law provision in a professional liability insurance policy that expressly provides for another jurisdiction's law to apply, a company's incorporation in Delaware is enough to make Delaware the default applicable law, especially in cases asserting breach of fiduciary duties.**

RSUI INDEMNITY COMPANY V. DAVID H. MURDOCK AND DOLE FOOD COMPANY, INC. ET AL.

The second coverage decision, *RSUI Indemnity Company v. David H. Murdock and Dole Food Company, Inc. et al.*, was a panel decision issued on March 3, 2021 by the Delaware Supreme Court. The underlying case arose out of a breach of fiduciary duty action and federal securities action following Dole's going-private merger transaction through which Dole's CEO acquired all of Dole's stock that was not previously owned by him.

Following a bench trial, the Chancery Court held the insureds had engaged in fraud and breached the duty of loyalty by engaging in an unfair, self-dealing transaction. As a result, the court assessed damages of approximately $148 million (or $2.74/share). Thereafter, Dole's insurers reserved their rights on coverage and the case was settled for the judgment amount and Dole's CEO, Murdock, paid the settlement plus interest. A related securities class action was settled following mediation without the insurers' involvement or consent for $74 million plus interest, of which one of Dole's excess insurers paid $7 million and Dole paid the remaining $66 million.

With the primary insurer's limits exhausted by defense costs, Dole's excess directors and officers insurance carriers argued that:

- California law, which bars insurance coverage for willful acts, should be applicable because the policies were negotiated and issued in California instead of Delaware, where Dole is incorporated;
- Even if Delaware law applied, Delaware law should determine that fraudulent conduct is uninsurable as a matter of Delaware public policy;
- The fraud/ personal profit exclusion is applicable to exclude coverage; and
- Allocation is appropriate due to the existence of an uninsured co-defendant and the CEO's dual capacity as controlling shareholder.

Coverage litigation resulted between Dole and its executives and RSUI, the only remaining excess insurer in the tower that neither paid its limit nor settled with Dole. The Delaware Superior Court found against RSUI and awarded its insured RSUI's $10 million policy limit, plus about $2.3 million in interest.

As in *Sycamore*, choice of law proved dispositive. However, as in the above caveat regarding New York law, while California does generally disfavor insuring restitution and disgorgement by both statute and public policy, the particular facts of each case will still be closely examined by a California court or a court applying California law, including whether there was a final adjudication of intentional fraud and whether an insured actually received ill-gotten gains. Here, Dole successfully argued that, at least when it comes to a D&O policy which insures directors and officers of a Delaware corporation, Delaware has the "most significant relationship" rather than the location of the underlying alleged wrongful acts that resulted in the claim. This decision also makes it quite clear that if the choice of law under a D&O policy comes down to a company's headquarters or its Delaware incorporation, incorporation in Delaware wins out as the most significant relationship and Delaware law will control.

While another state's policies must be considered, incorporation in Delaware is likely to tip the balance in favor of applying Delaware law because § 145 of the Delaware Corporations Law both permits Delaware corporations to provide broad indemnification and advancement rights to their directors and officers, as well as purchase D&O policies, which should respond even if indemnification is or becomes unavailable. Importantly, this serves to minimize the downside risks of serving as a director or officer through D&O insurance, which has the welcome effect of enhancing the ability of Delaware corporations to attract quality directors and officers, especially as over 50% of all publicly traded corporations and 63% of Fortune 500 companies are incorporated in Delaware. Thus, even if a company is headquartered in another state, its directors and officers live there, and a dispositive public policy differs from Delaware, a Delaware court will generally apply Delaware law if the company is incorporated in Delaware.

> In addition to reaffirming the insurability of punitive damages and ability to insure alleged intentional fraudulent conduct prior to a complete final adjudication of same, the Dole ruling also dealt with the insurer's attempt to allocate covered and uncovered loss based on the relative legal and financial exposures of the insureds. Rather than strictly applying the policy's "unhelpful" allocation provision which required best efforts to assess the relative legal and financial exposures, the court instead viewed the policy in its totality and applied the "larger settlement rule" which, in any event, would also likely have been applied under California law. **Under the larger settlement rule, a loss is fully recoverable (and not allocable) unless the insurer can concretely show that the liability for non-covered conduct increased the insurer's liability and ultimately, the amount of the settlement or judgment.**

WHAT YOU SHOULD KNOW

Given these favorable outcomes for the insureds in both cases primarily hinged on the application of Delaware law over that of another state, it is important to review your policies' choice of law provisions carefully with counsel. Some policies are silent on choice of law. Others require a clear choice be made. In all events, make sure your policy contains a "law most favorable to insurability" clause which operates as a choice of law clause. In the event a choice of law provision is required, consider the upsides of the above decisions and others that make clear that Delaware law is quite "policy-holder friendly." Where appropriate and available, carefully negotiate a favorable choice of law provision, keeping in mind that depending on the venue, a court could choose to ignore the policy's choice of law provision under certain circumstances.

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