Coronavirus And Your D&O Policies

by J. Wylie Donald

While the world took a "we're all in this together" approach in the early days of the COVID-19 crisis, the prolonged economic and human impacts are driving some investors to sue. Claims that a company should have done more, earlier, or better in dealing with COVID-19 are likely to increase. Board members will look to their directors' and officers' liability coverage for protection. Some clauses in your policies may deliver nasty surprises.

As I write this, I am on Day 46 of sheltering in place in the time of coronavirus. Dozens of cases have been filed by insureds seeking coverage for business interruption occasioned by government orders that have paralyzed the economy. We will see how those fare. Yet that is only the first wave of coverage cases, and on only one flavor of coverage—property insurance.

Rising in the distance is another wave, the claims under directors and officers (D&O) liability policies for lawsuits against companies for economic loss claiming mismanagement, misstatements, misfeasance and worse. How do we know this? Because the predicate claims have already been filed; indeed, some were filed even before I went into lockdown.

This article focuses on the allocation of coronavirus-connected economic loss between businesses and their insurers. As businesses recover, shareholders may second guess the decisions of management in preparing for and responding to the pandemic. The Securities and Exchange Commission or others may challenge the disclosures made by public companies. Still others may allege economic harm arising from the acts or omissions of the company and its officers, directors and employees.

Shareholders have been bloodied by the effects of coronavirus. The Dow Jones Industrial Average was, at one point, down 30 percent from its February 12, 2020 all-time high. Individual stocks have fared far worse. Norwegian Cruise Lines for example was down over 80 percent from February to April.

This did not go unnoticed. Two class actions were filed against Norwegian Cruise Lines in the Southern District of Florida claiming securities fraud. Among other things the improper stock trading of the company's CEO was alleged.

A pharmaceutical company has pursued a vaccine for COVID-19. Allegedly, the public statements by the president of the company apparently did not match reality. That led to a securities fraud class action and a derivative shareholder suit against Inovio Pharmaceuticals, Inc., both filed in the Eastern District of Pennsylvania.

Two critical questions are whether D&O policies exclude viruses or disease, and, if they do, whether those exclusions reach management and employees.

Prudent companies will have procured D&O policies to address such eventualities. Two critical questions are whether such policies have exclusions directed toward viruses or disease, and, if they do, whether those exclusions reach the actions or inactions of management and employees in a world of coronavirus.

Put simply, a D&O policy insures against economic loss associated with wrongful acts. Put less simply, a "wrongful act" may be defined as any actual or alleged breach of duty, neglect, error or omission, misstatement, or misleading statement.

An underlying complaint may assert a raft of theories arising from the wrongful acts. For example, the Inovio suit asserted "breaches of fiduciary duties as directors and/or officers of Inovio, unjust enrichment, abuse of control, gross mismanagement, waste of corporate assets, and for contribution under [federal securities laws]." If a wrongful act claim is brought, the D&O policy will provide or pay for a defense

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and indemnify for the loss—assuming all required conditions are met, and no exclusion applies.

That last part will be extremely pertinent. Although we have located no "pathogen" or "communicable disease" exclusion issued within a D&O policy, two possible exclusions are commonly found; a "pollution" exclusion and a "bodily injury" exclusion. Regardless of the wording, in many circumstances these types of exclusions should not always bar claims for coronavirus-connected wrongful acts. A typical pollution exclusion is set forth here:

> "This policy does not cover loss arising out of, based upon or attributable to the discharge, dispersal, release or escape of smoke, vapors, soot, fumes, acids, alkalis, toxic chemicals, liquids or gases, waste materials, or other irritants, *contaminants* or pollutants into or upon land, the atmosphere or any watercourse or body of water...(emphasis added)"

A carrier might invoke the exclusion asserting a lack of coverage for coronavirus "contamination."

A common bodily injury exclusion looks like this:

> "The underwriter shall not be liable to make any payment for any claim for any actual or alleged bodily injury, mental anguish, emotional distress, *sickness, disease* or death of any person, or damage to or destruction of any tangible property including loss of use thereof...(emphasis added)"

An insurer will assert that COVID-19 is a sickness or disease, and therefore excluded.

There are many blogs, alerts, websites and other publications stating that these exclusions will defeat coverage for a coronavirus D&O claim. Blanket statements like these should be rejected. While claims by sick cruise ship passengers against the cruise line, for example, probably belong under a general liability policy rather than a D&O policy with a bodily injury exclusion, in many instances (like those described above), exclusions truly have no place because bodily injury and pollution are not what the claims are about.

☐ *Example of a bodily injury exclusion in a breach of duty case.* The Georgia Court of Appeals rejected an insurer's attempt through reliance on a D&O policy's bodily injury exclusion to evade coverage for a corporate employee's failure to complete an application for a disability insurance policy. In *Fireman's Fund v. University of Georgia Athletic Association, Inc.,* the university sought disability insurance for its football players.

However, the university botched the application, and after one player was seriously injured, the disability carrier denied coverage. The player sued the university and the employee involved for failure to procure the coverage. Their D&O insurer denied coverage, relying on, among other things the policy's bodily injury exclusion.

The Various "Sides" Of D&O

Differing Policies, Differing Protection

When you as a director buy a policy you will probably want something called separate "Side A" protection. To understand what that means, you need to understand the "sides" of a D&O policy.

☐ ***Side B.*** The defense of an officer or a director starts with a demand for defense and indemnity by the officer or director to his or her corporation under the employment agreement with the corporation. To cover that risk, the corporation purchases Side B D&O coverage, which covers its obligations (usually subject to a deductible).

☐ ***Side A.*** When the corporation is unable (due to state law or financial incapacity) or is unwilling (a director may have a falling out with management) to defend and indemnify its officers and directors, they may proceed directly against Side A of the standard D&O policy (usually without paying a deductible).

☐ ***Side C.*** Legally, a corporation only acts through its agents. If a director or officer committed a liability-creating "wrongful act," then the corporation will also face liability. Thus, D&O policies sometimes also offer Side C coverage, which covers the corporate entity, and not the individual officers and directors.

Putting that all together, a prudent officer or director might be concerned about inadequate personal coverage. The limits of a particular policy might be rapidly used up by paying for the defense of all the officers and directors and the corporation, even without any indemnity payments. A director might be concerned that in a bankruptcy a court could attach the corporation's D&O policy as a corporate asset, and block a director from accessing the policy.

Prudent board members should therefore insist that their corporation provide a separate Side A policy that cannot be limited by claims against the corporation, or even by claims against other officers and directors.

"The D&O policy's bodily injury exclusion was broad and excluded any claim [a]lleging, *based upon or attributable to, arising out of, in consequence of or in any way related to* any bodily injury...(emphasis added)."

The insurer contended the claim arose out of the player's bodily injury, and there could be no coverage. The court of appeals concluded "that the nexus between [the player's] bodily injury and his claims against [the employee and the university entity] is too attenuated to bring his claims within the ambit of the bodily injury exclusion."

The finding of a lack of nexus was proper because there was no causal relationship between the conduct of the university and the player's injury. The insured's wrongful conduct did not cause or create the conditions giving rise to the player's injury. The player played without the protection of the disability insurance, and the insureds' wrongful acts were complete at the time of the injury. Accordingly, the bodily injury exclusion did not bar coverage and the insurer was required to provide a defense.

D&O policy language citing exclusions "based on, arising out of, or in any way involving" other factors can be very broad, and used to limit COVID-19 coverage.

☐ *Example of pollution exclusions in securities fraud cases.* Asbestos-related liabilities were at the heart of the class action against Sealed Air Corporation, or so its insurer asserted. In *Sealed Air Corp. v. Royal Indemnity Co.* in 2008, the company sought coverage for federal securities claims brought as the result of a sharp drop in its stock price. A federal bankruptcy court had ruled that a complex series of spinoffs, mergers and reorganizations was tainted by inadequate disclosures of asbestos liabilities.

Those transactions had lifted those liabilities from Sealed Air's balance sheet, but the liabilities threatened to return through the bankruptcy of the spun off entity. With creditors set to break down the corporate doors, Sealed Air settled the creditors' claims for $850,000,000. The securities claims ensued, which Sealed Air tendered to its D&O insurer.

The insurer denied coverage citing the pollution exclusion in the policy, which provided:

"The insurer shall not be liable for loss resulting from any claim made against any insured person, or with respect to insuring clause C, the company:

(6) *based on, arising out of, or in any way involving:*

(a) the actual, alleged or threatened discharge, release, escape, seepage, migration or disposal of pollutants into or on real or personal property, water, or the atmosphere; or

(b) any direction or request that the company or the insured persons test for, monitor, clean up, remove, contain, treat, detoxify or neutralize pollutants, or any voluntary decision to do so:

including without limitation any claim for financial loss to the company, its security holders or its creditors *based on, arising out of, or in any way involving* the matters described in subparts (a) or (b) above (emphasis added)."

Sealed Air sued. The trial court rejected the insurer's position and granted summary judgment. The insurer then appealed, arguing for a "literal reading" of the exclusion.

As would be expected, the stockholder plaintiffs linked their stock losses to the allegedly false and misleading statements made by Sealed Air, not to asbestos injury.

The New Jersey appellate court affirmed, but apparently would have enforced the D&O pollution exclusion where the "company's directors or officers were sued for polluting." In *U.S. Liquids v. National Union Fire Insurance Co. of Pittsburgh, Pa.* (2004), the Fifth Circuit Court of Appeals followed that course. In the case, the insured, a provider of "integrated liquid waste management services," allegedly illegally discharged liquid hazardous waste into Detroit's sewer system, along with illegal transportation and disposal of hazardous waste.

A criminal investigation and public disclosures led to suspension of trading in the company's stock, a fall in stock price, a securities class action and a shareholder derivative suit. Plaintiffs made the standard allegations of breaches of duty and reliance on materially false and misleading statements in the insured's press releases and SEC filings.

U.S. Liquids sought coverage for the suits from its D&O insurer. The policy contained a pollution exclusion, barring coverage for any loss in connection with a claim:

> "(1) alleging, arising out of, based upon, attributable to, or in any way involving, directly or indirectly:
>
> (1) the actual, alleged or threatened discharge, dispersal, release or escape of pollutants; (emphasis added)."

The insurer relied on the pollution exclusion to deny coverage, and then brought a declaratory judgment action.

Applying Texas law, the district court found that the pollution exclusion barred coverage of the underlying suits against the company. The Fifth Circuit affirmed. The broad "arising out of" language of the exclusion, required a "but for" test, which meant that there needed to be only an "incidental relationship" between the loss and the excluded conduct.

There are a number of important lessons here for policyholders facing coronavirus claims. First, in all of the cases discussed, the applicable exclusion contained broad language such as "arising out of" or "in any way involving" the excluded item. That will not always be the case.

Without broad "arising out of" language (as found in most current policies), an insured has a simple argument that the claim is not "for" bodily injury, and that the exclusion, on its face, does not apply. Going forward, insureds should seek D&O coverage without broad "arising out of" exclusionary language.

D&O policy ambiguities go against the insurer, and exclusions are construed narrowly.

Second, even where broad exclusionary language is present, rules providing favorable policy construction to the insured may mitigate its application. As stated by the Georgia Court of Appeals in *Fireman's Fund:*

> "When a provision of an insurance contract is ambiguous, "[t]hree well known rules apply in the construction of the contract: [a]ny ambiguities in the contract are strictly construed against the insurer as drafter of the document; any exclusion from coverage sought to be invoked by the insurer is likewise strictly construed; and [the] insurance contract [is] to be read in accordance with the reasonable expectations of the insured where possible."

Ambiguities go against the insurer, exclusions are construed narrowly, and the policyholder has "reasonable expectations" of coverage. These rules are not a panacea, but should be recognized and pressed in any discussion with a carrier. Note, however, the need to show ambiguity before the rules are applied.

Third, as in all coverage matters, the specific facts of the claim and law of the jurisdiction matter. In *Sealed Air* the complexity of the circumstances weakened the link between the excluded asbestos and the covered securities claim. In *U.S. Liquids* the court acknowledged that the applicable rule in Ohio would have led to a different outcome in Texas. Policyholders should be guided accordingly.

Coronavirus-related claims may be on the horizon for many business enterprises. These may include:

- Breaches of fiduciary duties of directors and officers, including duties of candor, good faith, loyalty, reasonable inquiry, oversight, and supervision.
- Unjust enrichment with respect to stock sales, stock grants or bonus awards.
- Abuse of control.
- Gross mismanagement.
- Waste of corporate assets such as excessive salaries and bonuses, lost opportunities, and alienation of investors and customers.
- Allegations of securities fraud.

Effective responses include documenting responsible approaches taken as the crisis built and unfolded, reliance on strong contractual terms, and preparing (and implementing) loss mitigation strategies. The response should also incorporate a company's insurance portfolio, with a plan to robustly pursue the coverage for which premiums were paid. ■