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Recent decisions underscore the importance of 'capacity' issues in accessing D&O insurance coverage

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Directors and officers often act in multiple capacities, but often the directors and officers liability policy purchased to protect those individuals includes "capacity" exclusions barring coverage for claims relating to a director's or officer's conduct in any capacity other than the capacity insured under the policy at issue.

At times, insurance companies deny D&O coverage based on the insurer's belief that the alleged wrongful acts were undertaken in the insured's capacity in a different role or because the insured was acting in dual or multiple capacities. However, recent federal decisions in New York and California highlight that, depending on the policy language at issue, D&O insurance policies may not preclude coverage when an insured is acting in multiple capacities.

Spicer v. National Union

In *Timothy Simon Spicer v. National Union Fire Insurance Co. of Pittsburgh, P.A.*,[1] security firm GardaWorld Consulting (UK) Limited purchased Aegis Defense Services, LLC and its parent company, Hestia B.V.

Recent federal decisions in New York and California highlight that, depending on the policy language at issue, D&O insurance policies may not preclude coverage when an insured is acting in multiple capacities.

Following the sale, Hestia's former shareholders sued GardaWorld for alleged misrepresentations made in connection with the sale. GardaWorld then asserted counterclaims against three of the plaintiffs who were both shareholders of Hestia and executives of Aegis.

The counterclaims alleged that the three plaintiffs engaged in fraud and aided and abetted fraud related to the Hestia acquisition, focusing on the acquisition of Aegis's business and representations made by the plaintiffs regarding the financial condition of Aegis.

The three plaintiffs named in the counterclaims sought coverage from National Union under a D&O policy sold to Aegis, which insured executives of Aegis, but did not insure Hestia.

The National Union D&O policy required National Union to "pay the Loss of the Company arising from a ... Claim made against an Individual Insured, for any Wrongful Act." The policy defined the term "Wrongful Act" as:

> with respect to any Executive or Employee of a Company, any breach of duty; neglect, error, or misstatement, misleading statement, omission or act by such Executive or Employee in their respective capacities as such, or any matter claimed against any Executive or Employee of a Company solely by reason of his or her status as an Executive or Employee of a Company.[2]

National Union refused to fund the defense on two grounds. First, it argued that the counterclaims did not meet the definition of "Wrongful Act" because they did not allege conduct by Aegis executives "in their respective capacities as such" or involve claims against such executives "solely by reason of his or her status" as an executive of Aegis.[3]

National Union also denied coverage under the policy's "capacity" exclusion, which provided:

> The Insurer shall not be liable to make any payment for Loss in connection with any Claim made against an Insured ... alleging, arising out of, based upon or attributable to any actual or alleged act or omission of an Individual Insured serving in any capacity, other than as an Executive or Employee of a Company.[4]

National Union argued that the plaintiffs had acted in their capacity as shareholders of Hestia in their negotiations to sell that company, rather than as executives of Aegis. At the very least, National Union asserted that the plaintiffs acted in a dual capacity, triggering the exclusion for losses arising from acts taken by the plaintiffs in "any capacity" other than as executives of Aegis.

The individual insureds filed suit, seeking a declaration that National Union was obligated to fund their defense and that National Union breached the parties' contract by failing to pay defense costs in accordance with the terms of the policy. The parties

filed dispositive motions turning on the issue of whether National Union was relieved of its obligation to pay defense costs under the policy's capacity exclusion.

The court held that National Union had a duty to defend the three executives in connection with the counterclaims. Applying well-settled rules of policy interpretation, the court reasoned that the definition of "Wrongful Act" contained two clauses, separated by the disjunctive conjunction "or," meaning that the insureds needed to satisfy only one clause to meet the definition.

The court stated that there was a "reasonable possibility" that the conduct alleged in the counterclaims constituted a "Wrongful Act" as described in the first clause of the definition of the term. There, a "Wrongful Act" requires only a "breach of duty, neglect, error, misstatement, misleading statement, omission or act by such Executive or Employee in their respective capacities as such."[5]

Thus, the court found that there was defense coverage for the claim because it "may reasonably be inferred that the plaintiffs acted in their roles as executives of Aegis" and because the counterclaims "clearly point to misstatements in the Aegis ... financial statements, which may be attributed to the plaintiffs acting in their capacity as executives of the company."[6]

The court further noted that the counterclaims did not expressly limit the liability of the plaintiffs to conduct committed in their roles at Hestia, as National Union contended, pointing to the second counterclaim, which "specifie[d] the capacity in which the plaintiffs made the alleged representations" on behalf of Hestia.

The court reasoned that the presence of this "limiting language" in the second counterclaim suggested that no such constraint existed in the first counterclaim.[7]

The court also refused to apply Exclusion 4(g), explaining that the counterclaims alleged misrepresentations in the financial statements of Aegis, which were later provided to GardaWorld. Because the counterclaims, as alleged, presented an issue of fact as to whether the plaintiffs acted "solely" in their capacity as officers of Aegis, the exclusion did not apply to foreclose defense coverage.[8]

XL Specialty Insurance v. AIG Specialty Insurance

In *XL Specialty Insurance Co. v. AIG Specialty Insurance Co.*,[9] a private equity firm, Prospect Capital Corporation, loaned Pacific World Corporation, a personal care and beauty products company, $215 million. Levine Leichtman Capital Partners owned 90% of Pacific World's stock and, as a result, LLCP placed five individuals on Pacific World's board of directors.

After the loan fell into default, Prospect Capital took control of Pacific World's voting stock and replaced the board of directors. Pacific World and Prospect Capital then sued LLCP and the LLCP-appointed directors and the court consolidated the two lawsuits for pre-trial purposes.

Pacific World alleged that its claims against each of the directors arose from their conduct as board members of Pacific World. It also alleged that the directors breached their fiduciary duties to Pacific World by approving the loan transaction and were liable as former directors of Pacific World for approving an unlawful distribution in connection with the transaction. Pacific World further alleged that LLCP breached its fiduciary duties to Pacific World as a *de facto* director by approving the loan transaction.

For its part, Prospect Capital alleged that the directors and LLCP aided and abetted the fraudulent transfers and engaged in civil conspiracy by approving the loan transaction. Prospect Capital's claims against the directors arose from their conduct as Pacific World board members.

The disputes that arose in these cases are not unique and frequently arise when insured directors and officers act in dual capacities and seek coverage under a D&O policy containing terms similar to those at issue in the National Union and AIG Specialty policies.

AIG Specialty Insurance Co. provided D&O coverage to Pacific World and its directors in their capacities as board members. LLCP and their executives, however, were not "Insureds" under the AIG Specialty policy. Rather, LLCP was insured under a separate set of policies, including an excess policy issued by XL Specialty Insurance Co.

XL Specialty provided coverage for the consolidated lawsuits, which it paid more than $3 million to defend and settle, and then sued AIG Specialty for not contributing its D&O Side A policy sublimit of $1 million toward the settled claim.

The AIG Specialty policy had a $1 million "Side A Excess Limit of Liability" that covered certain "Non-Indemnifiable Loss solely for Executives of a Company."[10] As in *Spicer*, the AIG Specialty policy also included a "capacity" exclusion, which stated:

> [T]he Insurer shall not be liable to make any payment for that portion of Loss in connection with that portion of any Claim made against an Insured ... alleging, arising out of, based upon or attributable to any actual or alleged act or omission of an Individual Insured serving in any capacity, other than as an Executive, Employed Lawyer, Controlling Person or Employee of a Company, or as an Outside Entity Executive of an Outside Entity.[11]

In support of its summary judgment motion, AIG Specialty argued that because the board members were also executives of LLCP, their dual affiliation meant that loss incurred in defense of their actions was not "solely for Executives," as required under the policy.

AIG Specialty also argued that the lawsuits related to the loan brought claims against the individual defendants in their capacities as executives of Pacific World *and* LLCP, which barred coverage under the capacity exclusion.

The court disagreed, finding that the AIG Specialty policy provided D&O coverage because the claims alleged against the directors in the underlying lawsuits relied on their status as Pacific World board members who approved the loan and distributions at issue.

The court reasoned that the directors would not have had an opportunity to approve the loan or the subsequent distributions "but for their positions as Pacific World board members."[12]

Next, applying the well-settled rule that courts must read exclusions narrowly, the court concluded that the capacity exclusion did not bar coverage.

First, the court held that the claims alleged against the board members did not "arise out of" any excluded acts because they were alleged against the board members in their capacities as Pacific World executives only.[13]

Second, the court held that the exclusion did not address "when liability arises from actions taken by covered executives in a covered and non-covered capacity. To the extent this creates an ambiguity, any ambiguous terms are resolved in the insureds' favor, consistent with the insureds' reasonable expectations."[14]

The court granted XL's motion for summary judgment and held that AIG Specialty was liable for $1 million in coverage plus pre-judgment interest.

Takeaways

The *Spicer* and *XL Specialty* decisions stress the long-standing principle that when determining the scope of coverage afforded to individuals acting in multiple capacities, the allegations in underlying pleadings must be read liberally in determining an insurer's duty to defend and that, if there is any doubt as to whether a policy affords coverage in light of those dual roles, it must be resolved in favor of the policyholder.

Likewise, they underscore that capacity exclusions must be read narrowly against the insurer and in favor of the policyholder. Moreover, in making those determinations, the facts alleged in the underlying claim, and not the insurer's self-serving characterizations or interpretation of those allegations, should control.

This is especially true at the motion-to-dismiss stage where the court must accept all of the policyholder's well-pled facts as true and draw all inferences in the policyholder's favor when identifying alleged wrongful acts against insured persons in their capacity, as such, or determining whether any exclusion bars coverage.

The disputes that arose in these cases are not unique and frequently arise when insured directors and officers act in dual capacities and seek coverage under a D&O policy containing terms similar to those at issue in the National Union and AIG Specialty policies.

This is prevalent in a number of industries, most notably in the private equity context, where individuals may be serving in multiple capacities on behalf of the private equity firm and the portfolio company in which the firm invests. It can also arise, as in the above disputes, where individuals serve in multiple capacities among affiliated companies.

Narrowing broad capacity exclusions, or even better, affirmatively clarifying that insureds acting in certain capacities (such as outside directors at portfolio companies) have coverage in their capacity as such, can eliminate insurer defenses, avoid coverage disputes centering around allocation of risk for individuals acting in multiple capacities, and help maximize recovery in the event of a claim.

Notes

[1] *Spicer v. Nat'l. Union Fire Ins. Co. of Pittsburgh, P.A.*, 1:20-cv-3784-GHW, 2021 WL 2809601 (S.D.N.Y. July 3, 2021).

[2] *Id.* at *1–2.

[3] *Id.* at *5.

[4] *Id.*

[5] *Id.* at *9.

[6] *Id.* at *9–10.

[7] *Id.* at *10–12.

[8] *Id.*

[9] *XL Specialty Ins. Co. v. AIG Specialty Ins. Co.*, 2:20-cv-06540-VAP, 2021 WL 3185451 (C.D. Cal., July 13, 2021). https://bit.ly/2VNc1iJ

[10] *Id.* at *6.

[11] *Id.* at *7.

[12] *Id.* at *14.

[13] *Id.* at *18.

[14] *Id.* at *19 (quotations omitted).

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