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INTRODUCTION

This paper provides a wide-ranging discussion of recent developments in shareholder litigation and governmental investigations and related issues involving directors and officers ("D&O") liability insurance. The paper begins with a discussion of recent trends in securities class action and derivative litigation, including a discussion on developments in litigation involving special purpose acquisition companies ("SPACs"). The paper will then discuss coverage disputes involving the "bump-up" exclusion in the context of underlying merger and acquisition ("M&A") litigation. The paper concludes with a discussion about D&O insurance coverage for governmental investigations, including whether such investigations constitute a "Claim" under D&O policies.

I. TRENDS IN SECURITIES CLASS ACTION AND DERIVATIVE LITIGATION

A. Securities Class Action Litigation

One of the most significant trends in securities class action litigation in 2021 was the number of securities litigation filings. The number of new securities class action filings in 2021 decreased significantly as compared to 2020.[1] In 2020, there were 333 securities class action filings which declined to 218 filings in 2021, the vast majority of which were filed in federal courts in New York and California.[2] According to the annual report from Cornerstone Research, the driving factor contributing to the decline in filings was largely due to the decline in M&A litigation filings as well as federal securities class actions alleging violations of Section 10(b) of the Exchange Act but no Section 11 allegations, which declined by 82% and 17%, respectively.[3] While the number of new securities litigation filings decreased in 2021, 2021 saw an increase in both the number and size of settlements in comparison to 2020. In 2021, there were 101 settlements reached for a total of $3.2 billion paid.[4]

Another trend in securities class action litigation has been the emergence of "event-driven" litigation, which results following a negative event about the company's operations and a drop in the company's share price. These cases are generally based on the theory that the occurrence of the negative event "was the materialization of an under-disclosed or downplayed risk."[5] Examples

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[1] CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS: 2021 YEAR IN REVIEW., *available at* https://www.cornerstone.com/wp-content/uploads/2022/02/Securities-Class-Action-Filings-2021-Year-in-Review.pdf.

[2] *Id*. at 1, 30 ("the Second and Ninth Circuits made up 72% of all core federal filings in 2021, the highest combined proportion for any two circuits since tracking began in 1997.").

[3] *Id*. at 4.

[4] Woodruff Sawyer, *Flash Report: 2021 Year-End Summary* (Feb. 8, 2022) 7 *available at* https://woodruffsawyer.com/wp-content/uploads/2022/02/Databox-Year-End-Flash-Report-2021.pdf.

[5] Jeffery A. Dailey, Neal Ross Marder, Akin Gump Strauss Hauer & Feld LLP, *The Rise in Event-Driven Securities Litigation – Why it Matters to Directors and Officers* (2018) *available at* https://www.akingump.com/a/web/99361/aokuj/the-rise-in-event-driven-securities-litigation-why-it-matters-to.pdf.

of event-driven litigation includes allegations related to COVID-19,[6] SPACs,[7] cyber breaches,[8] plane crashes,[9] sexual harassment,[10] the opioid crisis,[11] fake bank accounts,[12] among others. Plaintiffs typically allege corporate mismanagement in connection with the company's business operations and that previous statements made by the company with respect to the operational issue were false or misleading for failing to disclose the negative event.[13] Cornerstone reports that the most dominant trend that appeared in securities litigation filings in 2021 concerned SPACs, which we discuss in Section II below. In 2021, there were 33 SPAC-related securities filings, a sixfold increase from 2020.[14] Other recent trends that have appeared in securities litigation filings include securities filings related to COVID-19 (17 filings), cryptocurrency (11 filings), cybersecurity (6 filings), cannabis (4 filings), and opioids (2 filings).[15]

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[6] *See*, *e.g.*, *Martinez v. Bright Health Group*, Case No. 1:22-cv-00101 (E.D.N.Y.) (securities class action alleging false and misleading statements regarding ability to handle the impact of Covid-19 related costs); *Douglas v. Norwegian Cruise Lines*, Case No. 1:20-cv-21107 (S.D. Fl.) (securities class action alleging defendants misrepresented the impact of the COVID-19 outbreak on operations).

[7] *See*, *e.g.*, *In re Akazoo S.A. Securities Litigation*, Case No. 1:20-cv-01900 (E.D.N.Y. Sept. 8, 2020); *Borteanu v. Nikola Corporation*, Case No. 2:20-cv-01797 (D. Ariz. Jan. 24, 2022).

[8] *See*, *e.g.*, *In re: Marriott International, Inc., Customer Data Security Breach Litigation*, Case No. 8:19-md-02879 (D. Md.) (securities and derivative litigation arising out of Marriott's November 2018 announcement that it had uncovered a data breach in the guest reservation system dating back to 2014, exposing the personal data of over 500 million guests); *Litwin v. G. Michael Sievert, et al.* Case No. 2:21-cv-01599 (W.D. Wash.) (derivative litigation arising out of T-Mobile's August 2020 disclosure that customer personal identifying information for over 54 million customers was accessed by a hacker).

[9] *See*, *e.g.*, *In re The Boeing Company Aircraft Securities Litigation*, Case No. 1:19-cv-02394 (N.D. Ill.) and *In re The Boeing Company Derivative Litigation*, C.A. No. 2019-0907-MTZ (Del. Ch.) (securities class action and derivative litigation arising out of two plane crashes involving Boeing's 737 MAX, which resulted in the deaths of all 346 people on board).

[10] *See*, *e.g.*, *In re Alphabet Inc. Shareholder Derivative Litigation*, Case No. 19-cv-341522 (Cal. Super. Ct., Santa Clara Cty.) (derivative litigation alleging that certain current and former directors and officers of Alphabet, Google's parent company, breached their fiduciary duties in connection with the company's alleged mishandling of sexual harassment allegations against senior executives and the company's alleged pattern of sexual harassment and discrimination).

[11] *See*, *e.g.*, *In re McKesson Corporation Derivative Litigation*, Case No. 4:17-cv-01850 (N.D. Cal.) (derivative litigation arising out of McKesson's role in the nation's opioid crisis and the board's alleged failure to oversee the company's operations with respect to the distribution of prescription opioids); *In re Cardinal Health, Inc. Derivative Litigation*, Case No. 2:19-cv-2491 (S.D. Ohio) (derivative litigation pending arising out of allegations that for over a decade Cardinal, one of the largest pharmaceutical distributors in the U.S., failed to monitor and report suspicious orders of opioids in violation of the Comprehensive Drug Abuse Prevention and Control Act and similar state statutes).

[12] *See*, *e.g.*, *In re Wells Fargo & Company Shareholder Derivative Litigation*, Case No. 3:16-cv-05541 (N.D. Cal.) (derivative litigation arising out of Wells Fargo's alleged unfair sales practices and illicit creation of millions of deposit and credit card accounts for their customers without their consent in order to meet the bank's aggressive sales goals).

[13] Aon, *Client Alert: The New Wave of Securities Class Action Litigation – Mismanagement of Corporate Events Can Create Vulnerability* (April 2019) *available at* https://www.aon.com/getmedia/c071e33d-8469-492f-976c-b9d4378c453c/Aon-April-2019-Event-Litigation-April-Client-Alert.aspx.

[14] CORNERSTONE RESEARCH, *supra* note 1 at 5.

[15] *Id*.

While the continued success of event-driven litigation remains to be seen, we expect that corporations and their directors and officers will continue to look to their D&O insurers for coverage in defending against these risks.

B. Derivative Litigation

The most important recent trend in derivative litigation has been the move by the Delaware Supreme Court and the Delaware Chancery Court to tighten the standard of liability under the *Caremark* doctrine. These Delaware decisions are important since the Delaware Chancery Court is the leading forum for case law pertaining to the liability of directors and officers. Until recently, claims brought in derivative litigation against a company's directors for breach of their fiduciary duty to oversee and monitor the company's operations under *Caremark* has been described by the Delaware courts as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[16] Under *Caremark*, to state a claim for director oversight liability a plaintiff must allege facts establishing that either: (1) "the directors utterly failed to implement any reporting or information system or controls"; or (2) "having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."[17] However, in several recent Delaware derivative litigation decisions, beginning with *Marchand v. Barnhill*, plaintiffs have survived motions to dismiss, reflecting the Delaware courts' willingness to sustain *Caremark* claims, and underscoring the importance of board-level oversight.

In *Marchand v. Barnhill*, the Delaware Supreme Court held that allegations that the board of directors of an ice cream manufacturer that sold listeria-infected ice cream breached their fiduciary duties under *Caremark* for failing to oversee food safety, which was "essential and mission critical" for the company, were sufficient to withstand a motion to dismiss.[18] In particular, the *Marchand* court identified the following oversight failures by the board: (i) "no board committee that addressed food safety"; (ii) "no regular process or protocols that required management to keep the board apprised of food safety compliance practices, risks, or reports"; (iii) "no schedule for the board to consider on a regular basis, such as quarterly or biannually, any key food safety risks"; (iv) "during a key period leading up to the deaths of three customers, management received reports that contained what could be considered red, or at least yellow, flags, and the board minutes of the relevant period revealed no evidence that these were disclosed to the board"; (v) "the board was given certain favorable information about food safety by management, but was not given important reports that presented a much different picture"; and (vi) "the board meetings were devoid of any suggestion that there was any regular discussion of food safety issues."[19]

Just three months later, in another derivative suit, the Delaware Chancery Court further underscored *Marchand*'s emphasis on board oversight of "mission critical" business risks in *In re*

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[16] *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959, 967 (Del. Ch. 1996).

[17] *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

[18] 212 A.3d 805 (Del. 2019).

[19] *Id*. at 822.

Clovis Oncology Inc. Derivative Litigation.[20] In *Clovis*, the Delaware Chancery Court, citing *Marchand*, denied a motion to dismiss filed by the defendant directors of a monoline biopharmaceutical company whose prospects rested largely on one cancer drug that was undergoing FDA-regulated clinical trials. The court found sufficient the complaint's allegations that the directors breached their fiduciary duties under *Caremark* by failing to oversee the clinical trial and allowing the company to mislead the FDA and the market regarding the drug's efficacy.[21] Although the court recognized that the board had in place a board-level oversight system, the court found that the plaintiffs had sufficiently plead that the board failed to monitor it.[22] That is, "the Board consciously ignored red flags that revealed a mission critical failure to comply with the [clinical trial] protocol and associated FDA regulations."[23]

Most recently, on September 7, 2021, the Delaware Chancery Court sustained *Caremark* claims against the board of Boeing in *In re The Boeing Company Derivative Litigation*.[24] In *Boeing*, the court concluded that the plaintiffs sufficiently plead both prongs of *Caremark* oversight liability based on allegations that the directors failed to establish a reporting system for airplane safety and turned a blind eye to red flags regarding problems with airplane safety.[25] In so holding, the court found that "like food safety in *Marchand*, airplane safety 'was essential and mission critical' to Boeing's business, and externally regulated."[26] The court specifically referenced the *Boeing* plaintiffs' allegations that the defendants breached their fiduciary duties by failing to monitor and oversee the safety of Boeing's 737 MAX airplanes and that these oversight failures led to the 737 MAX crashes. The court explained that it "consider[ed] *Marchand*'s mandate that the board rigorously exercise its oversight function with respect to mission critical aspects of the company's business, such as the safety of its products that are widely distributed and used by consumers, as well as the failings *Marchand* identified as giving rise to the reasonable inference that the board faced a substantial likelihood of liability under prong one."[27]

As these decisions show, Delaware courts appear to be more likely to find that a plaintiff has met its burden under *Caremark* where the company operates in a highly regulated industry and the board is alleged to have a breached its duty of oversight with respect to a "mission critical" aspect of the company's business which results in death or injury. To defeat these claims, a board must not only be able to show that they have made a good faith effort to implement an oversight system, but that they also monitor that system, particularly when the company operates in a highly regulated industry.

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[20] 2019 WL 4850188 (Del. Ch. Oct. 1, 2019).

[21] *Id*. at *13-15.

[22] *Id*. at *13.

[23] *Id*. at *15.

[24] 2021 WL 4059934 (Del. Ch. Sept. 7, 2021).

[25] *Id*. at *26-34.

[26] *Id*. at *26.

[27] *Id*.

C. Mega Derivative Settlements

Related to the uptick in *Caremark* claims that have survived dismissal is the increasing escalation of record-breaking derivative settlements, a trend that is of great importance to D&O insurers. Historically, derivative settlements would typically only involve an agreement to adopt certain corporate therapeutics and a modest plaintiff's attorney's fee award and otherwise no cash component. However, in recent years there has been a proliferation of "mega" derivative settlements. While these large settlements are not exclusive to cases involving *Caremark* claims, of the ten largest derivative settlements, three recent settlements involved *Caremark* oversight claims. Those cases are the Wells Fargo, McKesson, and Boeing derivative litigations.

The Wells Fargo derivative litigation arose out of Wells Fargo's alleged unfair sales practices and illicit creation of millions of deposit and credit card accounts for their customers without their consent in order to meet the bank's aggressive sales goals; it settled for a $240 million cash payment.[28] The McKesson derivative litigation arose out of McKesson's role in the nation's opioid crisis and the board's alleged failure to oversee the company's operations with respect to the distribution of prescription opioids; it settled for $175 million.[29] The Boeing derivative litigation arose out of two plane crashes involving Boeing's 737 MAX, which resulted in the deaths of all 346 people on board; it settled for $237.5 million.[30]

This trend is especially noteworthy for D&O insurers as many of the large settlements were funded entirely by D&O insurance. This trend therefore has significant implications for D&O insurers and particularly with respect to "A-Side" coverage for non-indemnifiable claims. With respect to *Caremark* claims in particular, the massive settlements in these cases underscores that breach of the duty of oversight claims presents an increasing litigation risk to not only corporate boards but also their D&O insurers. In order to combat these risks, corporate boards should consider implementing an oversight system at the board level with respect to "mission critical" business risks, especially where the company operates in a highly regulated industry, and in the event of noncompliance, the board should take appropriate actions to remedy it.

II. DEVELOPMENTS IN SPAC LITIGATION

One of the most important developments in securities litigation during the last twenty-four months has been the explosion of "SPAC" cases. Special purpose acquisition companies ("SPACs"), also known as "blank check companies," are companies formed to raise capital through an initial public offering ("IPO") for the sole purpose of acquiring an existing company. At the time of their IPOs, SPACs have no existing business operations or identified targets for acquisition. Generally, SPACs have two years to complete a business combination, or it must return the IPO proceeds to the public

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[28] Stipulation and Agreement of Compromise, Settlement and Release, *In re Wells Fargo & Company Shareholder Derivative Litigation*, Case No. 3:16-cv-05541, Dkt. No. 270-1 (N.D. Cal. Feb. 28, 2019) (in addition to the $240 million cash payment, the Wells Fargo derivative settlement included the claw back of certain stock grants and incentive compensation valued at $60 million and certain corporate governance reforms valued at $20 million).

[29] Stipulation and Agreement of Compromise, Settlement, and Release, *In re McKesson Corporation Derivative Litigation*, Case No. 4:17-cv-01850, Dkt. No. 203-1 (N.D. Cal. Dec. 27, 2019).

[30] Stipulation and Agreement of Compromise, Settlement, and Release, *In re The Boeing Company Derivative Litigation*, C.A. No. 2019-0907-MTZ (Del. Ch. Nov. 5, 2021).

shareholders. SPAC IPOs have steadily increased since 2009 in both deal count and amount raised. During 2020, there was a wave of SPAC offerings, raising billions of dollars in capital.

The recent boom in SPACs has resulted in a surge of litigation and governmental investigations involving SPACs, raising concerns for D&O insurers. For example, as noted above, in 2021, there were 33 SPAC-related securities filings, a sixfold increase from 2020 and to date, there have already been six SPAC securities suits filed in 2022.[31] Litigation involving SPACs can arise during each phase of the SPAC life cycle and can take various forms, including, among others:

1. Merger objection suits brought against the SPAC parties challenging the business combination and alleging insufficient disclosures in connection with a potential de-SPAC transaction.

2. Direct or derivative claims for breach of fiduciary duty challenging the SPAC transaction. These suits typically focus on the structure of SPACs and alleged disclosure deficiencies, including: (i) allegations of conflicts of interest between the SPAC management team, on the one hand, and public investors, on the other; (ii) allegations that the way SPACs are typically structured unduly motivates the SPAC sponsor to rush to close a deal – even one bad for investors – otherwise the SPAC would liquidate, and the sponsor's shares would be worthless; and (iii) alleged deficiencies in the proxy statement for which the public investors decide whether to vote in favor of the de-SPAC transaction and exercise their redemption rights.[32]

3. Federal securities claims challenging SPAC transactions which typically allege materials misstatements and omissions regarding (i) overly optimistic revenue guidance and financial projections of the target company; (ii) the target's business operations and internal controls, including the company's technology, products or customers; (iii) histories of misconduct or investigations; and (iv) inadequate due diligence by the SPAC sponsor. Potential causes of action include violations of Sections 10(b), 14(a) and 20(a) of the Exchange Act and Section 11 of the Securities Act.[33]

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[31] CORNERSTONE RESEARCH, *supra* note 1; Stanford Securities Class Action Clearinghouse, *available at* https://securities.stanford.edu/current-trends.html.

[32] *See, e.g., Delman v. GigAcquisitions3, LLC*, C.A. No. 2021-0679 (Del. Ch.); *In re MultiPlan Corp. Stockholders Litigation*, C.A. No. 2021-0300 (Del. Ch.); *AP Services, LLP v. Lobell*, 2015 WL 3858818 (N.Y. Sup. Ct. June 19, 2015); *In re Nikola Corporation Derivative Litigation*, C.A. No. 2022-0023 (Del. Ch.); *In re XL Fleet (Pivotal) Stockholder Litigation*, C.A. No. 2021-0808 (Del. Ch.).

[33] *In re Akazoo S.A. Securities Litigation*, Case No. 1:20-cv-01900 (E.D.N.Y.) (alleging Section 10(b), Section 11 and Section 20(a) claims); *Borteanu v. Nikola Corporation*, Case No. 2:20-cv-01797 (D. Ariz.) (alleging Section 10(b) and 20(a) claims); *Lavin v. Virgin Galactic Holdings, Inc.*, Case No. 1:21-cv-03070 (E.D.N.Y.) (alleging Section 10(b) and 20(a) claims); *In re Romeo Power Inc. Sec. Litig.*, Case No. 1:21-cv-03362 (S.D.N.Y.) (alleging Section 14(a), Section 10(b) and Section 20(a) claims).

One trend that has emerged recently is SPAC securities litigation filed on the heels of a short-seller report criticizing the newly formed public company.[34] According to Cornerstone, 37% of all federal SPAC filings from 2019 to 2021 alleged one or more stock price drops as a result of a short-seller report.[35] In addition, one-third of all SPAC filings in 2021 involved the electric vehicle industry.[36]

4. Shareholder derivative actions which are often filed in parallel to related securities class actions and contain the same general allegations as alleged in those actions. These suits may also allege breaches of fiduciary duties by the SPAC's directors and officers in approving the de-SPAC transaction.[37]

From an insurance coverage perspective, SPAC-related litigation is noteworthy because of the potential of involving multiple towers of insurance and issues related to capacity and allocation. In this regard, claims involving SPACs may involve three separate D&O insurance policies issued to: (1) the SPAC; (2) the private target company; and (3) the go-forward public entity. However, some directors and officers may be involved with the SPAC and target company at different stages of the SPAC life cycle. For example, members of the SPAC may join the board of the going-forward public company. How do you allocate among the various towers of insurance when these individuals are then sued for wrongful acts occurring during different periods and in different capacities? Which policy(ies) are implicated, and which directors and officers are covered under each policy and in what capacity can lead to disputes between the insured and insurers as well as the various insurance towers.[38]

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[34] *Borteanu v. Nikola Corporation*, Case No. 2:20-cv-01797 (D. Ariz.); *In re Akazoo S.A. Securities Litigation*, Case No. 1:20-cv-01900 (E.D.N.Y.); *In re Lordstown Motors Corp. Securities Litigation*, Case No. 4:21-cv-00616 (N.D. Ohio).

[35] CORNERSTONE RESEARCH, *supra* note 1.

[36] *Id*.

[37] Other types of SPAC-related litigation include shareholder derivative suits against SPACs alleging that they qualify as investment companies under the Investment Company Act of 1940 (*see*, *e.g.*, *Assad v. Pershing Square Tontine Holdings, Ltd.*, Case No. 1:21-cv-06907 (S.D.N.Y.)); litigation against SPAC sponsors alleging liability against the sponsor based upon its control over the SPAC and the going-forward company (*see*, *e.g.*, *In re Alta Mesa Resources, Inc. Securities Litigation*, Case No. 4:19-cv-00957 (S.D. Tex.)); litigation by the SPAC shareholders against the SPAC for violating the corporate governance documents, such as suits challenging payments made from the trust fund upon the dissolution of the SPAC (*see*, *e.g.*, *Ruffalo v. TransTech Service Partners Inc.*, C.A. No. 5039-VCP, 2010 WL 3307487 (Del. Ch.) (shareholders' distribution rights are governed by the trust agreement)); suits alleging breach of contract and tortious interference with contractual relations against PIPE investors for allegedly breaching agreements in which they agreed to invest in the SPAC in connection with its de-SPAC transaction (*see*, *e.g.*, *Sustainable Opportunities Acquisition Corp. v. Ramas Capital Management, LLC*, Case No. 1:21-cv-07642 (S.D.N.Y.) and *Sustainable Opportunities Acquisition Corp. v. Ethos Fund I LP*, Case No. 1:21-cv-07640 (S.D.N.Y.) (both of these suits were voluntarily dismissed shortly after they were commenced)); litigation challenging the manner for soliciting the SPAC shareholders vote on a business combination (*see, e.g., Bass v. Mudrick Capital Acquisition Corporation II*, C.A. No. 2021-0690 (Del. Ch.)).

[38] *See* Boris Feldman, Freshfields Bruckhaus Deringer US LLP, *Tower Versus Tower: Implications of SPAC Shareholder Litigation for the D&O Insurance World* (Apr. 27, 2021), *available at* https://corpgov.law.harvard.edu/2021/05/12/tower-versus-tower-implications-of-spac-shareholder-litigation-for-the-do-insurance-world/.

III. BUMP-UP EXCLUSIONS

One of the principal purposes of public company directors and officers ("D&O") liability insurance is to protect directors and officers from exposure to shareholder lawsuits stemming from merger and acquisition ("M&A") activity. This protection has become only more important over the past decade as M&A claims have increased in both frequency and severity.[39]

In response to this escalation in underlying M&A litigation, D&O insurers increasingly have invoked the so-called "bump-up" exclusion ("BUE") to avoid covering M&A claims. According to insurers, the exclusion precludes coverage for settlements of M&A litigation that "bump up" the consideration that was paid to the shareholders of the target entity in the original M&A deal. But exactly when and how the BUE does so has been the subject of great debate and increasing amounts of novel litigation over the past five years.

We expect that there will be more litigation regarding the scope of the BUE, which is still in its early stages. As discussed further below, we also expect that such litigation will continue to involve disputes regarding whether, and to what extent, extrinsic evidence regarding D&O insurance industry custom and practice is relevant to the evolution of this issue.

1. Buyer v. Seller

One of the first issues that was litigated in this context is whether the BUE bars coverage for M&A claims against a policyholder that is the target entity in the underlying transaction.

Some in the D&O insurance industry have believed that the BUE applies only to M&A claims against the buyer entity, and not vice versa. The reason for this distinction is simple: insurers have not wanted policyholders to negotiate what policyholders know is a lowball price when buying another entity and then use insurance proceeds to supplement the price when they get sued. By contrast, when a policyholder's former shareholders allege that the policyholder's directors and officers failed to obtain the best possible price for the company, such alleged negligence is precisely the type of "wrongful act" that D&O policies cover.

Some insurers have used policy language specifying that the exclusion applies only to claims arising from transactions in which the policyholder is the buyer. But even where a policy does not contain such language, extrinsic evidence regarding, among other things, D&O insurance industry custom and practice and/or the policyholder and insurers' course of dealing, may still affect the outcome of litigation regarding the BUE, at least in jurisdictions that allow parties to use extrinsic evidence in the absence of a finding that policy language is ambiguous.

For example, in *Gardner Denver, Inc. v. Arch Insurance Company*, which was the first case to focus on this issue, the policyholder that paid the settlement was the target entity in the underlying

[39] Historically, settlements of M&A claims typically involved only additional disclosures and plaintiffs' counsel fees. More recently, however, multi-million-dollar settlements have become more common. *See, e.g.*, Gloria Gonzalez, *Merger objection lawsuits driving D&O rates up*, Business Insurance, Oct. 9, 2018, https://www.businessinsurance.com/article/20181009/NEWS06/912324459/Merger-objection-lawsuits-driving-directors-and-officers-rates-up.

transaction.[40] The policy's BUE barred coverage for the "amount representing, or substantially equivalent to, an increase in consideration paid or proposed to be paid in connection with any purchase of securities or assets of a Corporation." Even though the policy defined "Corporation" to include the policyholder, the Pennsylvania federal court denied the insurers' motion to dismiss the complaint. The court cited to the policyholder's detailed allegations regarding the above-referenced industry custom and practice and regarding the policyholder's own prior dealings with its insurers.[41] Of particular significance to the parties' course of dealing was the policyholder's allegations that the insurers previously had agreed that the BUE would apply only to claims arising from transactions where the policyholder was the buyer.

Conversely, the Superior Court of California for San Mateo County, after originally ruling that the language of the BUE was ambiguous and thus holding a bench trial to resolve that ambiguity, issued a proposed statement of decision in favor of the insurers based largely on evidence adduced at trial.[42] That evidence showed, among other things, that the primary insurer rejected a specific request from the policyholder's broker to amend the BUE to expressly apply only when the policyholder is the purchaser.[43]

Further, in *Joy Global Inc. v. Columbia Casualty Company*, the court rejected arguments by the policyholder regarding the history and purpose of the BUE because, in its view, Wisconsin law does not allow parties to introduce extrinsic evidence regarding insurance industry custom and practice or the parties' course of dealing when policy language is unambiguous.[44] Given the differing outcomes of the *Joy Global* court's decision applying Wisconsin law and the *Gardner Denver* court's decision applying Pennsylvania law, choice of law may be a significant factor in resolving disputes over the BUE.

2. Acquisition or Purchase v. Merger

Another issue that has recently become a focus of litigation is whether certain versions of the BUE apply to business combinations accomplished through mergers (such as reverse triangular mergers) or whether such exclusions apply only to pure acquisitions or purchases, meaning takeover transactions where the original target entity survives.

A recent decision issued by the Delaware Superior Court awarded summary judgment to the policyholder on this issue, stressing that the underlying transaction was accomplished through a reverse triangular merger, rather than an acquisition. Specifically, the court found that, under Delaware law, the BUE at issue is limited to acquisitions, which "in the corporate transactions context means a 'takeover of one corporation by another if both parties retain their legal existence

[40] *Gardner Denver, Inc. v. Arch Ins. Co.*, Civil Action No. 16-0159, 2016 WL 7324646 (E.D. Pa. Dec. 16, 2016).

[41] The parties subsequently settled after significant discovery on those issues.

[42] *Onyx Pharmaceuticals Inc. v. Old Republic Ins. Co.*, No. CIV 538248, 2020 WL 9889619 (Cal. Super. Ct. Oct. 1, 2020).

[43] *Id*. at *15.

[44] *Joy Global Inc. v. Columbia Casualty Co*., No. 2:18-CV-02034, 2021 WL 3667077, at *4 (E.D. Wis. Aug. 18, 2021).

after the transaction.'"[45] It therefore does not apply to a merger, which is a separate form of transaction and subject to its own distinct procedures.

Similarly, a Virginia federal court followed the Delaware decision and granted summary judgment to a policyholder on this issue, noting that there is extrinsic evidence that further indicates that the term "acquisition" in the BUE does not apply to mergers. For example, some policies treat mergers and acquisitions as separate forms of transactions when defining the term "Transaction."[46] In addition, there are policies in the marketplace that explicitly refer to both a "merger" and an "acquisition" in their BUE. Indeed, in response to these recent Delaware and Virginia decisions, "[m]any insurers who are no longer satisfied with their form wording—given this recent case law—have begun amending their bump-up language to broaden its applicability to any form of 'acquisition, merger, business combination, or other transaction.'"[47]

3. *Disparate* Consideration v. *Inadequate* Consideration

Another issue that has arisen is whether BUEs bar coverage where the underlying claim involves a dispute among shareholder classes. For example, the underlying M&A litigation at issue in a recent BUE case before the Superior Court of California for Los Angeles County was brought by the holders of only one class of the target entity's stock, who alleged that the transaction improperly favored the holders of another class of stock.[48]

Such M&A claims are significant because many BUEs in the marketplace refer only to a "Claim alleging that the price or consideration paid or proposed to be paid for the acquisition or completion of the acquisition of ***all*** or ***substantially all*** the ownership interest in or assets of an entity is inadequate" (emphases added). The parties in the above-mentioned Los Angeles case disputed what constitutes "all or substantially all the ownership interest in an entity." The policyholders pressed the position that the BUE does not bar coverage when the underlying claim complains of disparate consideration among holders of different classes of the target entity's stock, rather than claims by all of a target entity's shareholders that the overall price paid for the whole company was too low. The parties engaged in discovery on the issue but then settled before any ruling on it.

4. Plaintiff Attorneys' Fees

There also are disputes regarding whether the BUE reaches not only settlement payments made to shareholders themselves but also to plaintiffs' counsel fees included in the settlement. BUEs available in the marketplace vary on this issue. For example, one recent policy form expressly defines "Defense Expenses," which are exempted from this form's BUE, to include "that portion of any settlement which represents the claimant's attorneys' fees." Conversely, another BUE

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[45] *Northrop Grumman Innovation Sys., Inc. v. Zurich Am. Ins. Co.*, No. CV N18C-09-210, 2021 WL 347015, at *21 (Del. Super. Ct. Feb. 2, 2021); *see also Towers Watson & Co. v. National Union Fire Ins. Co. of Pittsburgh, PA*, No. 120CV810AJTJFA, 2021 WL 4555188, at *9 (E.D. Va. Oct. 5, 2021) (same).

[46] *Towers Watson & Co.*, 2021 WL 4555188, at *10.

[47] Gil Isidro, *M&A Litigation: Bump-Up Exclusions Update*, JD Supra, Jan. 13, 2022, https://www.jdsupra.com/legalnews/m-a-litigation-bump-up-exclusions-update-3947279/.

[48] *Starz Acquisition, LLC v. Allied World Assurance Co. (U.S.) Inc*., Case No. 18stcv04283 (Cal. Super. Ct.).

expressly specifies that there is no coverage for plaintiffs' counsel fees. The majority of BUEs are silent on the issue.

The applicable state law may have a major impact on the outcome of such disputes. Some jurisdictions find that an insurer's failure to use available language expressly excluding coverage implies its intent to provide such coverage. Moreover, there is evidence regarding D&O insurance industry custom and practice that supports the view that plaintiffs' counsel fees are covered unless explicitly excluded. As just one example, a slide deck provided by an insurer-side law firm states that an "award of plaintiffs' attorneys' fees is not excluded" and that "[e]ven multiplied portion of attorneys' fees [are] covered because policy did not expressly preclude them."[49]

5. Defense Costs

Most, but not all, BUEs contain express carve-backs providing coverage for defense costs incurred by insureds to litigate underlying M&A claims. But, regardless of whether a BUE specifies this exemption, the custom and practice in the D&O insurance industry is that BUEs do not apply to defense costs. Thus, although insurers and policyholders often squabble about whether defense costs were reasonable or incurred without the insurer's consent, we are unaware of any dispute about whether the BUE bars such coverage entirely.

6. Related Issues Regarding Coverage for Alleged Controlling Shareholders

Some M&A claims arise from transactions involving target entities that have purported controlling shareholders who allegedly violated their fiduciary duties to the company and their fellow shareholders. In such cases, policyholders may need to show that the policy provides "control person" coverage.[50]

This issue could be relevant because, if the insurers believe that the allegedly controlling shareholder is not an insured, they likely will try to allocate liability to that shareholder to reduce their coverage obligations. Furthermore, if the settlement of the underlying case includes a release/indemnification of the alleged controlling shareholder that was not expressly approved by the insurers, the insurers may seek to void coverage based on a purported breach of the subrogation clause in the D&O policies. Thus, showing that the alleged controlling shareholder is an insured person is critical because many subrogation provisions preclude subrogation claims against an insured person.

This issue was hotly contested in the above-mentioned Los Angeles case, where the court denied an insurer motion for summary judgment based on such a subrogation defense. The court ruled that the "unrefuted evidence" in the case established that the alleged controlling shareholder was

[49] Fundamentals of, and Insurance Coverage for, Merger Objection Suits, https://media.lockelord.com/files/Uploads/Documents/Fundamentals%20of%20and%20Insurance%20Coverage%20for%20Merger%20Objection%20Suits%20-%20The%20Basics%20PRESENTATION%207-17-13.pdf.

[50] *Starz Acquisition, LLC v. Allied World Assurance Co. (U.S.) Inc*., Case No. 18STCV04283, Slip Op. at 9–12 (July 30, 2020).

an insured (despite not being a current director or officer of the policyholder), and the subrogation clause in the policies precluded the insurers from subrogating against their insured.[51]

IV. GOVERNMENTAL INVESTIGATIONS / "CLAIMS"

Another issue that recently has been the subject of significant litigation is whether, and to what extent, D&O policies cover losses incurred in connection with governmental investigations. This issue is a hotly disputed one under both private company and public company D&O insurance policies.

The costs of compliance with a government subpoena or other investigatory demand can be substantial. And, risk of being faced with such costs has only increased because the Biden Administration has committed to aggressive oversight of the business community. The Securities and Exchange Commission has been afforded more leeway to start investigations.[52] Further, the Department of Justice is in the process of hiring more attorneys to enforce the tougher enforcement policies that Deputy Attorney General Lisa O. Monaco announced last year.[53]

The cost of addressing such subpoenas and other investigatory demands is substantial because a failure to comply can come with significant consequences. For example, non-compliance with a subpoena carries a risk of contempt-of-court findings and corresponding penalties.

The issue of whether such costs are covered often turns on what constitutes a "Claim" (or a "Securities Claim") under the policy at issue. Many D&O policies define "Claim" broadly to mean both "a written demand for monetary or non-monetary relief made against any Insured" and "a civil, criminal, administrative or arbitration proceeding . . . made against any Insured seeking monetary or non-monetary relief and commenced by the service of a complaint or similar pleading, the return of an indictment, or the receipt or filing or any notice of charges or similar document . . . ." Some policies' definitions of "Claim" also include additional subsections that specifically encompass government investigations, but those subsections often limit coverage to individual directors and officers. Specifically, an individual director or officer must be the target of an investigation.

Policyholders and insurers have long disputed whether a subpoena or other investigatory demand constitute "a written demand for non-monetary relief" or involve a "proceeding commenced by

[51] *Id*. at Slip Op. 11–12.

[52] *See, e.g.*, Dave Michaels, *SEC Expands Enforcement Staff's Power to Start New Investigations*, Wall St. J., Feb. 9, 2021, https://www.wsj.com/articles/sec-expands-enforcement-staffs-power-to-start-new-investigations-11612894490#:~:text=The%20number%20of%20new%20investigations,it%20reached%20526%20in%202019.

[53] Jack Queen, *Garland Vows DOJ Headcount Surge In White Collar Blitz*, Law360, Mar. 3, 2022, https://www.law360.com/articles/1470180/garland-vows-doj-headcount-surge-in-white-collar-blitz; *see also* Stewart Bishop, Deputy AG Unveils New Tacks For White Collar Enforcement, Law360, Oct. 28, 2021, https://www.law360.com/articles/1435544/deputy-ag-unveils-new-tacks-for-white-collar-enforcement; U.S. Dep't of Justice, *Attorney General Merrick B. Garland Delivers Remarks to the ABA Institute on White Collar Crime*, Mar. 3, 2022, https://www.justice.gov/opa/speech/attorney-general-merrick-b-garland-delivers-remarks-aba-institute-white-collar-crime.

the service of a complaint or similar pleading, the return of an indictment, or the receipt or filing or any notice of charges or similar document." Courts have split on this issue.

Many courts have agreed with policyholders that such investigatory demands qualify as a "Claim" under the above-quoted definitions.[54] For example, one Illinois federal court found that subpoenas issued by the Securities and Exchange Commission were demands for non-monetary "relief" because the definition of "Claim" in the policy could include a demand for something "due," including producing documents or appearing to testify.[55] It also found that such a subpoena was "not a mere request for information, but a substantial demand for compliance by a federal agency with the ability to enforce its demand" and thus constituted a "Claim" under the policy.[56]

Similarly, a New York state court considered whether there was coverage for defense costs resulting from subpoenas served as a result of both state and federal investigations into a former employee, which required the production of documents and records maintained by the policyholder. Although the insurer argued that the subpoenas were not "Claims" under the policy, the court found that the grand jury's "subpoenas constitute a 'written demand . . . for non-monetary relief'" and thus constituted a covered claim under the policy.[57] It also found that the subpoenas and investigations constituted "criminal proceedings for monetary or non-monetary relief" that were commenced by a "return of an indictment, information or similar document" and thus satisfied that separate prong of the definition of "Claim."[58]

By contrast, other courts have agreed that such investigatory demands do not qualify as a "Claim" under the above-quoted definitions.[59] For example, one federal appellate court held that subpoenas

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[54] *Agilis Benefit Servs. LLC v. Travelers Cas. & Sur. Co. of Am.*, No. 5:08-CV-213, 2010 WL 8573372, at *6 (E.D. Tex. Apr. 30, 2010) (under "majority" approach, federal grand jury investigation and search warrant authorizing the seizure of documents constitute "written demand for monetary or nonmonetary relief"); *MBIA Inc. v. Federal Ins. Co.*, 652 F.3d 152, 162 (2d Cir. 2011) (finding coverage for federal and state investigations because each was "commenced by a 'formal or informal investigative order or similar document' and is therefore a 'Securities Claim'" under the policy); *Protection Strategies, Inc. v. Starr Indem. & Liab. Co.*, No. 1:13-CV-00763, 2013 WL 10724338, at *2 (E.D. Va. Sept. 10, 2013) (finding that NASA subpoena and search warrant fall within policy's broad definition of "Claim" under "both written demands for non-monetary relief and as judicial proceedings commenced by service of a complaint or similar pleading.").

[55] *Minuteman Int'l Inc. v. Great Am. Ins. Co.*, No. 03 C 6067, 2004 WL 603482, at *7 (N.D. Ill. March 22, 2004).

[56] *Id*.

[57] *Syracuse Univ. v. National Union Fire Ins. Co. of Pittsburgh, PA*, 40 Misc. 3d 1205(A), at *2–3 (N.Y. Sup. Ct. 2013), *aff'd*, 112 A.D.3d 1379 (N.Y. 2013).

[58] *Id*. at *2 (quoting the policy language at issue).

[59] *Employers' Fire Ins. Co. v. ProMedica Health Sys., Inc.*, 524 F. App'x 241, 252 (6th Cir. 2013) ("the subpoenas and CIDs issued by the FTC in August 2010 do not meet the elements of a 'claim' [because they] sought information related to the FTC's investigation, not a remedy provided by a court"); *Diamond Glass Companies, Inc. v. Twin City Fire Ins. Co.*, No. 06-CV-13105 BSJ/AJP, 2008 WL 4613170, at *4 (S.D.N.Y. Aug. 18, 2008) ("Grand jury subpoenas and search warrants do not fit within this meaning of the term 'relief' or fall within a reasonable reading of the use of the term in the context of the Policy."). The Sixth Circuit in *Employers' Fire Insurance* also distinguished the above-referenced pro-policyholder *Minuteman* decision by pointing out that the insurer in *Employers' Fire Insurance* did exactly what the *Minuteman* court said would be necessary to preclude coverage under the "written demands for non-monetary relief" prong of the definition of "Claim," namely, tying the requested "relief" to a "Wrongful Act." 524 F. App'x at 253; *see also MusclePharm Corp. v. Liberty Ins. Underwriters, Inc.*, 712 F. App'x 745, 754 (10th Cir. 2017)

do not constitute written demands for non-monetary relief because they do not request a remedy from a court.[60]

Another wrinkle is that, as noted above, some policies contain different definitions of "Claim" that are specific to "Insured Persons" and the "Insured Organization," respectively, and only the definition specific to "Insured Persons" includes subpoenas and investigatory demands. A federal court in Maryland rejected an insurer's argument that the difference in language meant that the company was not covered for "work performed in responding to the subpoena issued by the Florida Attorney General's Office."[61] But this specific issue has not been the focus of much judicial interpretation, and courts may split on this issue, too.

As the differing court decisions show, choice-of-law, and thus choice of forum, could play a significant role in the outcome of disputes over this issue. As noted in the prior section, that also is true regarding disputes over the BUE.

(making same point to distinguish another pro-policyholder case on this issue). It also is important to note that an expansive definition of "Claim" does not always favor policyholders. For example, in *Employers' Fire Insurance*, it was the insurer arguing in favor of a broad definition of "Claim" to support an argument that "Claim" arose well before the policyholder tendered it to the insurer and thus that the policyholder failed to provide timely notice. 524 F. App'x at 253.

[60] *MusclePharm Corp.*, 712 F. App'x at 754 ("'Relief' is defined as 'legal remedy or redress,' or as '[t]he redress or benefit,' especially 'equitable in nature (such as an injunction or specific performance), that a party asks of a court.'").

[61] *Education Affiliates Inc. v. Fed. Ins. Co*., No. CV -JFM-15-1624, 2016 WL 4059159, at *2 (D. Md. July 28, 2016) (rejecting insurer's position that inclusion of the word "subpoena" in the definition of "Claim" for individual directors and officers and corresponding omission of that word from definition of "Claim" for the insured company meant that a subpoena did not constitute a "Claim" against the insured company); *see also, e.g., Reiter v. Sonatone Corp.*, 442 U.S. 330, 339 (1979) ("terms connected by a disjunctive," such as "or," should "be given separate meanings").