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The D&O Diary

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Delaware Court: Pre-Merger Target Company Execs Are Insured Persons Under SPAC'S Post-Merger Tail Policy

By Kevin LaCroix on February 21, 2023

In yet another Delaware court D&O insurance coverage decision that is sure to set the D&O insurance industry spinning, a Delaware Superior Court Judge has held that a SPAC's post-merger runoff policy provides coverage for the defense fees of former directors of the pre-Merger target company for alleged Wrongful Acts that the occurred prior to the merger – even though the former directors were not directors or officers of the SPAC at the time they allegedly committed the alleged Wrongful Acts. The court's ruling could even further complicate the already fraught process of placing and structuring D&O insurance in the De-SPAC context. A copy of the Court's February 6, 2023 opinion can be found **here**. (Please note that I have linked to the copy of the opinion on the Court's website; the website copy to which I linked says that the opinion was filed under seal, but the seal reportedly was lifted by the court on February 16, 2023.)

Background

Social Capital Hedosophia Holdings Corp. III ("Social Capital") is a special purpose acquisition company (SPAC). Social Capital completed an IPO in April 2020. Clover Health Investments Corp. ("Legacy Clover") was a private health insurance company. Social Capital and Legacy Clover merged on January 7, 2021, to form a go-forward company referred to in the coverage litigation as Clover Health.

At the time of its IPO, Social Capital purchased a program of D&O insurance consisting of a layer of primary insurance and two layers of excess insurance. When Social Capital and Legacy Clover merged, Social Capital's D&O insurance program went into run-off. The insurers in the run-off program are referred to in the coverage litigation as the Tail Insurers and their policies are referred to as the Tail Policies, or, collectively, the Tail Program.

At the time of the merger, Clover Health separately purchased a program of D&O insurance for the go-forward public company, consisting of a layer of primary insurance and two layers of excess insurance. Clover Health's go-forward insurance program is referred to in the coverage litigation as the Go Forward Program, with the insurers known as the Go Forward Insurers.

Following the merger, Clover Health became involved in a variety of legal matters: a securities class action lawsuit (about which refer **here**); a shareholder derivative lawsuit; shareholder demands under Section 220 of the Delaware Corporations Code; and an SEC investigation. Clover Health notified both the Tail Insurers and the Go Forward Insurers of these matters.

The primary insurer on the Tail Program accepted coverage for the securities claims and derivative claims against the former directors and officers of Social Capital but denied coverage for the securities litigation and the derivative litigation with respect to the individual defendants in the lawsuits who were directors of Legacy Clover but who were not directors of Social Capital prior to the merger. The primary insurer in the Tail Program also denied coverage with respect to the SEC investigation, on the grounds that the investigation did not constitute a Claim within the meaning of the policy. The primary Tail Insurer also took the position that it was entitled to an allocation under its policy between covered and non-covered defense costs.

Clover Health filed a declaratory judgment action against both the Tail Insurers and the Go-Forward Insurers. The Tail Insurers filed a motion to dismiss, arguing that the former Legacy Directors were not "Insured Persons" within the meaning of Social Capital's Tail Policies. Clover Health filed a motion for partial summary judgment against the Tail Insurers, seeking a ruling that the Tail Insurers have a duty to pay defense costs. The Go-Forward Insurers and the Go-Forward Insurance was not involved in the Court's considerations of the Tail Insurers' and Clover Health's motions.

Key Policy Provisions

The Primary Tail Policy defines "Insured Persons" as "Any one or more natural persons who were, now are or shall become duly elected or appointed directors, trustees, governors, Managers, in-house general counsel, controller, risk manager, advisory director or member of a duly constituted committee or board of the Company or their functional equivalent."

The Primary Tail Policy defines the term "Wrongful Act," in relevant part as "any error, misstatement, misleading statement, act, omission, neglect, or breach of duty actually or allegedly committed or attempted by any of the Insured Persons in their capacity as such, or in an Outside Position, or with respect to Insuring Agreement C, by the Company."

The February 6, 2023, Opinion

In a February 6, 2023, opinion, Delaware Superior Court Judge **Mary M. Johnston** granted Clover Health's motion for partial summary judgment, and largely denied the Tail Insurers' motions to dismiss although she granted the Tail Insurers' dismissal motion with respect to Clover Health's claim for breach of the covenant of good faith and fair dealing.

In ruling that the former Legacy Clover directors were "Insured Persons" under the Tail Policies even though they were not directors or officers of Social Capital prior to the merger, Judge Johnston put a great deal of emphasis on the inclusion within the term "Insured Persons" of persons who "shall become" directors of the Company and also of the inclusion in the definition of the term "functional equivalents." Based on this language, she accepted Clover Health's argument that a future director or officer of Clover Health is the "functional equivalent of a Social Capital director or officer."

In reaching this conclusion, she noted that in the definition of "Insured Persons," the term "functional equivalent" comes after the phrase "of the Company," and therefore she found that "functional equivalent" is not modified by "of the Company." Thus, she said, an "Insured Person could be someone associated with another entity that is not Social Capital if that person operated in a functionally equivalent role to a director or officer of Social Capital."

Judge Johnston then went on to observe that the former directors of Legacy Clover allegedly assisted with Social Capital's filings in connection with the merger – "while they were still directors and officers of Legacy Clover" – the individuals "allegedly committed the wrongdoing concerning Social Capital's SEC filings while in positions of control as future directors and officers of Clover Health – these individuals were acting in functionally equivalent roles to Social Capital's directors and officers when they committed the wrongdoing." Based on her analysis, Judge Johnston found,

the "plain language" of the definition of Insured Persons in the Tail Policies requires the inclusion in the term of the former directors and officers of Legacy Clover.

With respect to the question of whether or not the former directors of Legacy Clover were acting "in their capacity" as "Insured Persons" at the time of the alleged Wrongful Acts, Judge Johnston said that "it would have been more clear if the language had said that an Insured Person must have been a director or officer at the time the Wrongful Act was committed." She said further that "it also would have been more clear if the language had said that 'Insured Persons' includes individuals who were not directors or officers as of the policy date, but the individuals' alleged Wrongful Acts took place while they were 'in their capacity' as 'Insured Person.'"

With respect to the question of coverage for the SEC Investigation, Judge Johnston concluded that because subpart 6 of the primary Tail Policy's definition of Claim removes investigatory proceedings from the definition of Claim while subpart 9 includes Formal Investigations, the definition is "ambiguous," owing to the "directly contradictory language in Subparts 6 and 7," holding that the Court will permit discovery as to the ambiguity.

As to the allocation issue, Judge Johnston relied heavily on the Delaware Supreme Court's holding in the Murdock case (discussed **here**), concluding, in reliance on the Supreme Court's opinion, that the Larger Settlement Rule applies not only to Settlements but also to defense costs. In application of the Larger Settlement Rule, she concluded, with respect to the question of whether or not the defense costs were increased by the presence of uninsured parties or matters, that the defense costs were not increased, and therefore that the Tail Insurers are required to advance all defense costs for the securities lawsuit and the derivative lawsuits.

Finally, she granted the Tail Insurers' motion to dismiss as to Clover Health's claim for breach of the implied covenant of good faith and fair dealing, because she concluded that the claim was "not different from the alleged conduct for Clover Health's breach of contract claim."

Discussion

I confess that I frequently find it difficult to write about the Delaware courts' D&O insurance coverage decisions. Here, I find it particularly troublesome to address Judge Johnston's conclusion that there is defense cost coverage for the former directors and officers of Legacy Capital under Social Capital's Tail Policy even though the Legacy Capital directors were not directors and officers of Social Capital prior to the merger (that is, at any time before the Tail Policies went into runoff). I would have thought it would be sufficient here to conclude that — even if the primary Tail Policy's definition of "Insured Person" includes persons who "shall become" directors and officers of Social

Capital – there can be no coverage under the Tail Policies for those individuals because they were not "Insured Persons" at the time they committed the alleged Wrongful Acts.

Judge Johnston nevertheless concludes that the former Legacy Capital executives were acting in their capacities as insured persons at the time of the alleged pre-merger wrongful acts, based on the inclusion in the definition of "Insured Person" of those who "shall become" directors and officers of Social Capital, and the inclusion in the definition of the term "functional equivalent."

In doing so, she accepted Clover Health's argument that "a future director or officer of Clover Health is the functional equivalent of a Social Capital officer or director." She is able to complete this leap because the phrase "functional equivalent" is not, she says, modified by the prior phrase "of the Company." Thus, she is able to further conclude that "an Insured Person could be someone associated with another entity that is not Social Capital if that person operated in a functionally equivalent role to a director or officer of Social Capital." In reaching this conclusion, Judge Johnston asserts that she is relying on the "clear language" of the policy.

As a preliminary matter, I have concerns that Judge Johnston's use of and reference to the phrase "functional equivalent" disregards the purpose of the phrase in the policy. An experienced D&O insurance professional would know that the "functional equivalent" language is there to make sure that individuals serving in officer or other "equivalent" positions for foreign subsidiaries or other entities organized under foreign laws are included as persons insured under the policy. The "functional equivalent" language literally has nothing to do with to the operation of the policy with respect to persons who may become directors and officers after the policy incepts.

I have further concerns about Judge Johnston's using the "functional equivalent" phrase as she does. Her conclusion depends on the supposed linguistic logic that the phrase "functional equivalent" comes after the phrase "of the Company," and therefore the words "of the Company" cannot modify the phrase "functional equivalent." However, I believe that even though the phrase "functional equivalent" comes after "of the Company," the language of the definition of "Insured Person" taken as a whole does not support her ultimate conclusion, and in fact supports a contrary conclusion. In that regard, it is critical to note that the phrase is not just "functional equivalent," but it is rather "*their* functional equivalent":

> "Any one or more natural persons who were, now are or shall become duly elected or appointed directors, trustees, governors, Managers, in-house general counsel, controller, risk manager, advisory director or member of a duly constituted committee or board of the Company or their functional equivalent."

Thus, even if the term "functional equivalent" comes after the term "of the Company" in the definition, the phrase's reference to "*their* functional equivalent" signifies that the preceding language ending with the phrase "of the Company" modifies and defines the phrase "functional equivalent." Because the policy refers not just to the "functional equivalent" but to "*their* functional equivalent," the phrase "functional equivalent" cannot be read in isolation from the phrase ending with the words "of the Company," because the phrase "their functional equivalent" means functionally equivalent to directors and officers, and holders of other offices, "of the Company."

Perhaps there will be some readers who think my reading of the definition of "Insured Persons" is forced; I would argue it is no less forced than the interpretation accepted by Judge Johnston. In any event, my reading provides an alternative possibility to Judge Johnston's conclusion that her reading is the only one that could be drawn from the "clear language" of the definition.

I have further concerns about the way the various insurance programs are made to operate in light of Judge Johnston's interpretation. A great deal of care goes into the structuring of D&O insurance in connection with De-SPAC transactions to make sure that there are separate funds of insurance set up to address the liability exposures of separate groups of individuals. Judge Johnston's reading of this policy blurs the lines between the various programs in the structure. It is hard enough to structure D&O insurance for De-SPACs as it is, and it can only be further complicated if the careful structures are disregarded.

I also have concerns about Judge Johnston's conclusions on the allocation issue but my concerns here follow the same concerns I have about Delaware Supreme Court's treatment of the allocation issue in the Dole Foods case, and rather than making an already long blog post even longer here by recapitulating those concerns, I incorporate by reference here **my discussion of those issues in connection with the Dole Foods opinion**.
