Lawyer Insights

D&O Coverage Considerations for M&A and Government Investigations

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Published in Business Law Today | March 25, 2024

Macroeconomic factors and market indicators point to a rebound in M&A activity in 2024. An increase in deals necessarily affects many directors and officers (D&O) insurance policies in ways that could lead to future coverage disputes, as policy provisions addressing changes in control take effect and so-called tail policies are implemented. At the same time, federal and state regulators continue to put pressure on companies and their directors and officers, whether through increased regulatory requirements—like the recent amendments to Form PF adopted by the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC), impacting how large hedge fund advisers report investment exposures—or through heightened enforcement associated with developments like the SEC's new cybersecurity disclosure rules and growing crypto assets and cyber unit. These and other circumstances heighten the risk of both M&A and regulatory exposures that may implicate coverage under D&O and management liability policies.

Last month, a California federal judge held that a D&O liability insurer must advance subpoena-related defense costs on behalf of two former biotech directors and officers after the insurer could not provide conclusive evidence that the subpoenas alleged actual wrongdoing by the individuals after the company's merger, as required to trigger the policy's "Change in Control" exclusion.[1] The decision highlights the interplay of two significant D&O coverage issues—government investigations and M&A transactions—and underscores why policyholders must pay close attention to how their liability insurance policies may by impacted by a merger, acquisition, asset sale, or similar deal.

BACKGROUND

In 2020, KBL Merger Corp. IV (KBL) purchased primary and excess D&O policies with $5 million in limits. Later that year, KBL changed its name to 180 Life in a merger that involved the resignation of its CEO and all directors. Following the merger, the SEC opened an investigation and issued subpoenas to KBL's former CEO and a former director. 180 Life demanded coverage for the expenses it advanced to the former director and officer in connection with the subpoenas. The primary insurer filed a declaratory action asserting that 180 Life was not an insured under the policy issued to KBL (the pre-merger entity) and, in any event, that the subpoena-related expenses were subject to the policy's "Change in Control" exclusion.

The parties disagreed over whether the policy's advancement clause was triggered when there were "potentially covered" claims or whether the duty to advance defense costs was limited to "actually covered" claims. After consideration of the policy language and relevant case law, the court found that the advancement clause required the insurers to advance defense costs for potentially covered claims, consistent with California law. The court then turned to whether coverage for the SEC subpoenas was

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barred by the application of the Change in Control exclusion, which turns on *when* the alleged wrongful acts are alleged to have been committed or attempted.

THE CHANGE IN CONTROL EXCLUSION

The Change in Control exclusion barred coverage for claims "alleging in whole or in part any Wrongful Acts committed, attempted or allegedly committed or attempted" by the individual insureds after the merger. The court first noted that an insurer that wishes to rely on an exclusion has the burden of proving, through "conclusive evidence," that the exclusion "applies in all possible worlds." As applied in the context of the Change in Control exclusion, the insurers needed to show that the subpoenas alleged post-merger wrongful acts by the insureds.

That showing, the court acknowledged, was difficult to make in the context of a subpoena, which merely requests documents, compared to a civil complaint containing specific allegations of wrongdoing.

The insurers emphasized that the SEC subpoenas requested documents relating to both pre-merger and post-merger time periods and urged the court to infer from those requests that the subpoenas allege both pre-merger and post-merger wrongful acts. The court declined to make that "logical leap" and ultimately concluded that the insurers failed to meet the high burden of conclusively showing that the Change in Control exclusion applied. The court recognized, however, that the insurers may be able to make this showing at a later date. If so, they will be able to recoup any advanced defense costs that turn out not to be covered.

TAKEAWAYS

Time and time again, insurers argue that government subpoenas are not covered under D&O policies because they do not allege any wrongful acts by insureds and, as a result, cannot trigger insuring agreements requiring that demands for documents be "for Wrongful Acts." Here, where it supported a complete disclaimer, the insurers took the opposite position that the subpoenas alleged wrongful acts simply because the document requests related to post-merger time periods. The court correctly applied the high burden required for insurers to deny coverage based on exclusions where it determined that the subpoenas did not allege wrongful acts—they only requested documents.

More broadly, the context in which this dispute arose—a government investigation following a merger—also highlights the importance of coordinating coverage in the context of M&A deals. This includes not only carefully examining the scope of exclusions that may defeat coverage for claims that only allege *in part* conduct during the excluded time period, but also reviewing liability policies covering directors and officers before and after closing to ensure continuity of coverage and avoid unexpected gaps in coverage.

All companies, whether currently contemplating a transaction or not, need to understand how their D&O policies account for changes in control. Legacy D&O policies typically provide going-forward coverage in the event of a sale, and imprecise policy wording or overbroad exclusions may result in finger-pointing and coverage gaps if left unaccounted for. Working closely with insurance brokers, consultants, and outside coverage counsel can help identify these issues, work towards mitigating deal-related risks, and minimize surprises if a D&O claim arises after closing.

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Notes

1. *See* AmTrust Int'l Underwriters DAC v. 180 Life Scis. Corp., No. 22-CV-03844-BLF, 2024 WL 557724 (N.D. Cal. Feb. 12, 2024). ↑

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