# Eye on the Experts

## *GOGGIN* AND THE D&O INSURANCE 'CAPACITY' EXCLUSION: A POTENTIAL COVERAGE GAP FOR PRIVATE EQUITY AND OTHER INVESTOR-DESIGNATED DIRECTORS

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Private equity sponsors, hedge funds, and other investment entities who bargain for seats on their portfolio companies' boards often assume that their director-designees will be fully covered by the portfolio companies' directors and officers ("D&O") insurance policies. But as a Delaware court recently ruled in *Goggin v. National Union Fire Insurance Company*, a typical D&O policy's "capacity" exclusion may preclude coverage for acts that a director-designee takes in anything but his *exclusive* capacity as the insured company's board member and fiduciary. In other words, a designated director facing allegations that he or she acted to further the appointing sponsor's interests, rather than solely to further the portfolio company's, may not be covered.

While the *Goggin* court was not the first to reach such a holding, the case highlights how critical the capacity exclusion can be. Investing sponsors need to be aware of the exclusion and should proactively work with their portfolio companies, and the companies' insurers and brokers, to close the potential coverage gap.

### The Facts and Holding from *Goggin*

The plaintiffs in *Goggin* were two former directors of a coal company that filed for Chapter 7 bankruptcy in 2014. They also were investors in two unaffiliated limited liability companies, which they had formed several years earlier, purportedly to reinvigorate the struggling coal company through various debt purchase and other restructuring arrangements. Their efforts to save the coal company from bankruptcy failed, however.

The company's unsecured creditors subsequently asserted fiduciary breach claims against the directors based on their dealings with and interests in the LLCs. At bottom, the lawsuit alleged that the two directors, by securing advantageous repayment and priority terms for the LLCs in connection with the restructuring transactions, defrauded the company and its creditors.

The directors sought coverage for the lawsuit under the coal company's D&O policy, but the insurer denied their claim. Since the lawsuit arose from acts that the directors allegedly had committed at least in part to benefit the LLCs, the insurer argued that the lawsuit fell within the policy's capacity exclusion, which barred coverage for any claim "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 [the Insured] Company." The directors then filed a declaratory judgment action against the insurer to challenge its coverage denial.

Finding for the insurer, the court focused on the capacity exclusion's use of the phrase "arising out of." The court held that "arising out of" means "originating from . . . incident to, or having connection with," and thus hinges on the application of a broad "but-for" test. The court explained that because the creditors likely would not have brought the fiduciary breach claims but for the acts that the directors allegedly took to benefit the LLCs—i.e., acts taken in an "uninsured capacity"—the exclusion was triggered.

To be clear, the holding from *Goggin* is not an outlier. The insurer in *Goggin* was not the first to deny coverage based on a capacity exclusion. Nor was the *Goggin* court the first to uphold such a denial. However, the issue has not been frequently litigated and thus often is overlooked.

Notably, courts in other states also have reached similar conclusions, based on reasoning like that underpinning the *Goggin* decision, even where the relevant policies did not include capacity exclusions.1 This is because D&O policies typically cover "Wrongful Acts," a term which commonly is defined as any actual or alleged error, omission, or breach of duty "committed or attempted by an Insured Person *in his or her capacity as such*, or any matter claimed against an Insured Person *solely by reason of his or her status as such.*" This definition may effectively create the same coverage limitations as an express capacity exclusion.

## Practical Implications

As *Goggin* makes clear, the capacity exclusion (as well as the standard definition of Wrongful Acts) pose serious risks to portfolio company board members designated by hedge funds or other private equity sponsors. While both the sponsor and the designated director surely would expect the portfolio company's D&O policy to protect the designee, that may not be the case if he or she is alleged to have acted in the sponsor's interests.

This potential coverage gap, though, can be closed with light revisions to the policy wording, or through negotiation of a custom endorsement. Investing sponsors should keep these fixes in mind when negotiating with prospective portfolio companies.

## Note

1. *See, e.g., Carlson v. Twin City Fire Ins. Co.*, No. 09-608, 2009 WL 1793887, at *3-4 (D. Minn. June 23, 2009) (holding that an insured president was not covered where he was alleged to have acted "in furtherance of his personal business," such that "his wrongful conduct did not 'arise solely' out of the discharge of [his] duties on behalf of" the insured association); *Beck v. Am. Cas. Co. of Reading, Penn.*, No. MO-88-CA-303, 1990 WL 598573, at *11, 14-15 (W.D. Tex. Apr. 12, 1990) (holding that the defendant-insurer had no duty to defend the plaintiffs against claims arising from acts they took as the insured company's shareholders, rather than "in their sole capacity as the [company's] officer or directors").

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