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Insureds Should Fear Exclusions With Broad Preambles

By **Catherine Doyle and Jan Larson** (March 5, 2019, 12:14 PM EST)

Catherine Doyle

Jan Larson

The U.S. District Court for the Middle District of Florida, applying Florida law, recently held that an insurer had no duty to defend or indemnify its insureds under a private company D&O insurance policy where the wrongful acts in question were held to be inextricably tied to securities transactions broadly excluded by a nonstandard securities exclusion in the policy.

In Colorado Boxed Beef Co. Inc. v. Evanston Insurance Co., the court held that an exclusion for claims "[b]ased upon, arising out of or in any way involving" the sale of securities extended to allegations of self-dealing and corporate theft despite the insureds' contention that they could stand alone from the excluded securities claims. In so holding, the court found that these allegedly wrongful acts were the means by which the insureds allegedly accomplished the excluded securities fraud.

The insureds have appealed the decision. While the insureds have filed an appeal in the Eleventh Circuit, the district court's willingness to apply the exclusion to arguably independent wrongful acts counsels policyholders to carefully analyze the exclusions, including the preamble language, contained in their D&O policies. In addition, although the Colorado Boxed Beef opinion focused solely on the construction and application of a D&O policy, the underlying plaintiffs' claims may have been covered under a seller-side representations and warranties policy tailored to the disputed transaction, had such a policy been procured.

We therefore urge policyholders to consider alternative coverage options, such as representations and warranties policies, to avoid potential gaps in coverage where broad exclusions may defeat coverage under other types of insurance.

In the underlying action that formed the basis for the later coverage action in Colorado Boxed Beef Co. Inc. v. Evanston Insurance Co.,[1] Colorado Boxed Beef Co. Inc., a private company, and four of its directors and officers were sued in Polk County, Florida, by former holders of CBB securities who had sold their shares to three of the four CBB officers and directors as part of a prior stock purchase agreement transaction on or about April 1, 2015.

The sellers alleged that the CBB directors and officers made misrepresentations and omissions of material facts relating to factors that deflated CBB's stock price to the advantage of the directors and

officers who bought the devalued shares. Specifically, the sellers alleged misrepresentations by those directors and officers and in the form of corporate theft, excessive compensation, usurpation of corporate opportunities and self-dealing. Through this fraudulent conduct, the sellers alleged that the directors and officers acquired the CBB shares with CBB's funds rather than with their own money.

The sellers brought seven causes of action against CBB and its officers and directors under Florida statutory and common law, including fraud in the inducement, negligent misrepresentation, violation of Florida Statute section 517.301 relating to securities transactions, breach of fiduciary duty, unjust enrichment, conspiracy to defraud and rescission of the SPA.

CBB had a private-company for profit management liability insurance policy with Evanston Insurance Company, including a directors and officers and company liability coverage part. This coverage part provided that "[t]he Insurer shall pay on behalf of the Insured Persons all Loss ... which the Insured Persons became legally obligated to pay on account of any Claim … for a Wrongful Act taking place before or during the Policy Period."

"Wrongful Act," in turn, was defined in the policy as "[a]ny actual or alleged error, misstatement, misleading statement, act, omission, neglect or breach of duty." However, the policy also contained a securities exclusion — Exclusion K — for claims "[b]ased upon, arising out of or in any way involving...the actual, alleged or attempted purchase or sale, or offer or solicitation of an offer to purchase or sell, any debt or equity securities[.]"

While it is relatively standard for a securities exclusion to appear in a private company D&O insurance policy, the formulation of the exclusion in most other policies is quite different than Exclusion K in this policy. Specifically, a standard securities exclusion in a private company D&O insurance policy is worded such that is does not apply to preclude coverage for all transactions in securities; rather, it applies to preclude coverage only for public securities transactions. In the D&O coverage part of the policy issued to CBB, Exclusion K contained no such limitation as to the public securities transactions.

Faced with this lawsuit from the sellers, CBB and the directors and officers sought a defense and indemnification from Evanston under the D&O coverage part of the policy. Evanston refused to defend the insured in the underlying lawsuit and denied coverage, contending that Exclusion K applied.

The insureds filed suit for declaratory judgment regarding Evanston's duties to defend and indemnify them with regard to the underlying lawsuit. Evanston moved to dismiss the insureds' first amended complaint on the grounds that Exclusion K applied. The district court agreed but permitted the insureds to amend their complaint. The insureds filed a second amended complaint and Evanston again moved to dismiss based on Exclusion K. On Jan. 2, 2019, the court granted Evanston's motion to dismiss, this time with prejudice.

In its order, the court began its analysis by examining Exclusion K's preamble language, noting that the Florida Supreme Court has held "arising out of" to be a broad and unambiguous phrase meaning "having a connection with." The court likewise found the phrase "or in any way involving" to be commonly used and broad in its interpretation. Because of the broad preamble language in Exclusion K, the court concluded that the exclusion would preclude coverage that "in any way" involves security sales.

Applying that broad interpretation of the exclusion, the court concluded that the underlying lawsuit involved and arose from the sale of securities. The complaint was styled as an action for damages or

rescission arising from misrepresentations in connection with the officers and directors' purchase of the CBB shares. The SPA was attached as an exhibit to the complaint, and each count in the underlying complaint sought its rescission. In the court's view, each and every claim in the underlying complaint directly connected the insureds' alleged conduct to the SPA, and the court pointed to language in each count that related to the SPA or the securities transaction.

The insureds attempted to escape application of the exclusion by arguing that the complaint alleged activity that preceded the SPA and continued after its execution. Further, one of the four directors and officers named in the underlying lawsuit was not a party to the SPA. The insureds analogized this case to Lime Tree Village Cmty. Club Association Inc. v. State Farm Gen Insurance Co.,[2] in which an insurer had a duty to defend its insured for claims including slander, disparagement of title and restraint of trade, despite language in the policy stating that it "does not apply" to malicious and intentional acts and acts in violation of civil rights law.

Rejecting the insureds' attempts to draw a parallel between the two cases, the court in Colorado Boxed Beef disposed of the insureds' argument on the grounds that the activities pre- and post-dating the SPA and the fourth officer and director's involvement were only relevant to the underlying complaint because they related to the SPA. Whereas the Lime Tree court found that the underlying plaintiffs did not need to prove intent to prevail against the insured for their claims, and therefore the exclusion did not apply, the Colorado Boxed Beef court considered the alleged misrepresentations and omissions during negotiations of the SPA central to the underlying claims.

The Colorado Boxed Beef court further distinguished Lime Tree by noting that "does not apply" is narrower than the "arising out of" and "in any way involving" preamble language to the relevant exclusion in the CBB policy. The court stated that the insureds made a "valiant effort" in their second amended complaint to reshape the underlying complaint's focus from rescission of the SPA and damages related to the sale of securities to stand-alone "claims" for "wrongful acts" covered by the policy. However, the court disagreed that the allegations of self-dealing and corporate theft could, in fact, stand alone from the securities fraud alleged by the underlying plaintiffs.

The court therefore held that Exclusion K applied, and Evanston had no duty to defend or indemnify the directors and officers. The court dismissed the second amended complaint with prejudice. On Jan. 28, 2019, the insureds filed an appeal to the Eleventh Circuit, which is currently pending.

The district court's decision in Colorado Boxed Beef serves as a cautionary tale to policyholders regarding the reach of an exclusion with such broad language as the "[b]ased upon, arising out of or in any way involving" preamble language and lacking the standard public securities transaction limitation that defeated insureds here. We recommend that policyholders carefully review the exclusions to their D&O policies, taking particular note of broad preamble language to exclusions that may serve to subsume acts preceding or post-dating the excluded conduct, as well as any unusual formulations of otherwise standard policy provisions. Where such items exist, insureds may be able to work with their insurance brokers or outside counsel to obtain more favorable terms.

In addition, in the Colorado Boxed Beef case, a seller-side representations and warranties policy specific to the transaction that formed the basis of the underlying suit may have provided coverage otherwise barred under the D&O coverage part's nonstandard securities exclusion. As a result, we urge policyholders to consider all available coverage options in connection with a particular transaction, to avoid potential gaps in coverage where broad exclusions may defeat coverage under other types of insurance.

Catherine L. Doyle is an associate and Jan A. Larson is a partner at Jenner & Block LLP.

[1] Colorado Boxed Beef Co. Inc. v. Evanston Insurance Co., No. 8:18-cv-1237-T-02JSS, 2019 WL 77376 (M.D. Fla. Jan. 2, 2019)

[2] Lime Tree Village Cmty. Club Ass'n, Inc. v. State Farm Gen Ins. Co., 980 F.2d 1402 (11th Cir. 1993)