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Client Alert

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Delaware Federal Court Ruling Highlights Important D&O Insurance Issues in Merger

On May 23, 2022, the United States District Court for the District of Delaware issued a decision on two important issues impacting D&O insurance rights for acquiring companies and their directors and officers following a merger. *See Liberty Insurance Underwriters, Inc. v. Cocrystal Pharma, Inc.*, No. 1:19-cv-02281-JDW-CJB, 2022 WL 1624363, at *5 (D. Del. May 23, 2022). Liberty Insurance Underwriters, Inc. sued Delaware policyholder Cocrystal Pharma, Inc. seeking recoupment of defense costs Liberty paid on behalf of Cocrystal in connection with an SEC investigation. The investigation concerned an alleged 2013 "pump and dump" scheme purportedly perpetrated by certain directors and officers of Biozone Pharmaceuticals, Inc. in an effort to inflate Biozone's share price. Cocrystal acquired Biozone via merger in 2014, at which time the individuals involved in the alleged scheme became directors and officers of Cocrystal.

The SEC issued subpoenas to Cocrystal in 2015, and by 2018 the SEC had filed suit, naming three Cocrystal (former Biozone) executives as defendants. Additionally, Cocrystal shareholders filed derivative lawsuits alleging harm to Cocrystal from the scheme and for ongoing failure of Cocrystal management to disclose the scheme. Liberty had advanced approximately $1 million in defense costs in connection with the SEC's investigation, but in court it sought recoupment of those costs and a ruling that it had no obligation to cover the derivative actions. In ruling in favor of Liberty, the Court addressed two important issues that executives should keep in mind when structuring corporate acquisitions.

First, the Court affirmed the emerging rule in Delaware that Delaware state law will apply to D&O insurance issues, including alleged bad faith by the insurer, for companies incorporated in Delaware, regardless of where those companies are headquartered or operate. Every state has "choice of law" rules that its courts apply to determine what law must be used to interpret a contract that has contacts with multiple states. The well-reasoned Delaware rule should give executives confidence that a Delaware court will apply Delaware law to a Delaware corporation's D&O insurance policy because the risk being insured is "the directors' and officers' 'honesty and fidelity' to the corporation." Delaware state laws and rules regulate corporate governance for a Delaware corporation, so Delaware state law will also govern the interpretation of the

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contract insuring against the liability risks arising from purported violation of those laws and rules.

Second, the Court found that common insurance policy language precluded coverage for the costs of defending Cocrystal's executives against allegations of bad acts. The Cocrystal policy defined Insured Persons as Cocrystal's directors and officers, and it defined Wrongful Act to include "any actual or alleged error, misstatement, misleading statement, act, omission, neglect, or breach of duty, actually or alleged [sic] committed or attempted by the Insured Persons in their capacities as such . . ." *Liberty Insurance Underwriters*, 2022 WL 1624363, at *5 (emphasis added). Since the alleged pump and dump scheme arose before the merger of Biozone and Cocrystal, the Court denied coverage because the defendants faced allegations of liability in connection with Biozone-related activity—not activity as executives of Cocrystal. The Court held that there was no alleged "Wrongful Act" triggering Cocrystal's policy. Further, because the derivative actions were filed after Cocrystal policy's expiration, the Court denied coverage for those lawsuits as there was no earlier claim of a Cocrystal-related "Wrongful Act" that would trigger the policy's relation back clauses.

This decision highlights the potential gap in liability protection that can arise when an acquired company's D&O coverage expires as the result of a merger, particularly when directors and officers of the acquired company take on similar positions in the new entity. Sophisticated executives understand that "tail" or "run-off" coverage is available that will allow continued reporting of claims under the expiring company's D&O insurance. Stakeholders should give due consideration to potential legacy liabilities in connection with any transaction—whether a simple asset purchase or a full acquisition of an entity—and seek the advice of insurance professionals to maximize insurance protection and prevent gaps from arising in a liability insurance program.

Please contact the Olshan attorney with whom you regularly work or the attorney listed below if you would like to discuss further or have questions.[1]

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