

D&O Insurance and the Two Words to Fear: Capacity Exclusion

by E. Eric Rytter

The Delaware Superior Court recently held in *Goggin v. National Union Fire Insurance Co.*^[1] (which you can read [here](#)) that private equity sponsors also serving as portfolio company directors may, under certain circumstances, not be covered by D&O insurance as a result of a so-called “capacity exclusion” in the policy. A “capacity exclusion” is an exclusion of coverage for claims relating to directors acting in any capacity other than as a director. The specific “capacity exclusion” at issue in *Goggin* read as follows:

The Insurer shall not be liable to make any payment for Loss in connection with any Claim made against an insured:

(g) alleging, arising out of, based upon or attributable to any actual or alleged act or omission of any individual Insured serving in any capacity, other than as an Executive or Employee of a Company, or as an Outside Entity Executive or Outside Entity.

The court concluded that this exclusion was clear and unambiguous, and when applied to the facts, necessitated the exclusion of D&O coverage.

The case involved Goggin and Goodwin, each a member of the private equity sponsor that also served as directors of the portfolio company. During their term as directors of the portfolio company, they attempted to reinvigorate the portfolio company through debt repurchase and other capital restructuring, in part by forming two investment vehicles. Ultimately, the reinvigoration efforts did not work, and the company entered into bankruptcy when its creditors filed a petition under Chapter 7 of the Bankruptcy Code. Various claims alleged that Goggin and Goodwin breached their fiduciary duties and favored their own personal interests with respect to the investment vehicles by diverting assets for personal gain and entering into unfair contracts that benefitted Goggin and Goodwin personally, all at the expense of the portfolio company. The court found that the claims in question “arose out of” Goggin’s and Goodwin’s capacity as members of the investment vehicles and were therefore covered by the “capacity exclusion” even though the claims “related too to their co-existence as . . . directors.” As a result, the court

Related People

- E. Eric Rytter

Related Capabilities

- Private Equity
- Corporate Governance & Compliance

denied coverage based on the “capacity exclusion.”

The Delaware Superior Court’s decision has made it clear that the “capacity exclusion” can torpedo the protection that a D&O insurance policy provides. If directors designated by the private equity sponsor act in any capacity other than as a director of the portfolio company, there is a risk the capacity exclusion will be invoked. This decision is particularly unsettling because many of our private equity clients depend on the protection a D&O policy provides, as a D&O policy typically covers a variety of claims, including breach of fiduciary duty.

Furthermore, this decision is in tension with settled practice based on prior Delaware case law dealing with similar “dual fiduciary” capacity issues. *Levy et al v. HLI Operating Company, Inc.* (Del. Ch. May 16, 2007) held that investment funds providing indemnification to their principals who serve on portfolio company boards are co-indemnitors with the portfolio company for recovery purposes. Following on this decision, PE sponsors now often include “Levy language” in portfolio company indemnification agreements and governing documentation specifying the primacy of portfolio company insurance coverage. Levy language relating to indemnification will not make a “capacity exclusion” provision in a portfolio company’s D&O policy inapplicable. And the expansive reading of “capacity exclusion” by the *Goggin* court could put representative directors serving on portfolio company boards at risk of noncoverage under a broad range of circumstances in which they are arguably playing multiple roles in furtherance of what they believe is the best interest of the portfolio company.

Going forward, private equity sponsors should (i) review D&O policies carefully to determine whether a capacity exclusion is included and (ii) if a capacity exclusion is present, work with insurance brokers to either limit or eliminate such exclusion.

[1] This decision has been appealed to the Delaware Supreme Court.