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Split Panel of the Seventh Circuit Rules Largely in Favor of Policyholder on Defense Issues for Nassar USAG Sexual Assault Claims Under D&O Policy

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Insights for Insurers

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On February 25, 2022, a split panel of the Court of Appeals for the Seventh Circuit issued a decision on D&O coverage for the Nassar USAG sexual assault claims. The lengthy opinion is worth reading in its entirety, but we provide a summary of the ruling below, which was favorable to the policyholder on defense issues.

Facts and Procedural History

Larry Nassar sexually assaulted hundreds of girls and young women over decades during his involvement with USA Gymnastics, Inc. (USAG), As a result of 'Nassar's abuse, USAG has been sued numerous times and investigated by Congress and federal and state authorities. Liberty Insurance Underwriters, Inc. (Liberty) issued a claims-made D&O liability insurance policy to USAG.

The Nassar-related litigation and investigations forced USAG into bankruptcy, which stayed an Indiana state coverage action. In an adversary proceeding, the bankruptcy court issued proposed findings of fact and conclusions of law, including, among other things, that the initial Nassar-related claims were timely made and that a wrongful-conduct exclusion applied to only those claims for which Nassar was criminally convicted. The district court adopted those findings and conclusions in a January 13, 2020 order. Liberty appealed to the Seventh Circuit.

Jurisdiction

As a threshold matter, the Seventh Circuit determined that it had jurisdiction to entertain the interlocutory appeal because the order subject to appeal had the "practical effect" of an injunction. The order subject to appeal granted relief on the merits, obligating Liberty to defend USAG on a going-forward basis and pay an undetermined amount of defense costs and fees. Further, the panel noted that, if such order is incorrect, Liberty's recovery may be limited because USAG is bankrupt.

The parties agreed that Indiana substantive law controlled, and the Seventh Circuit decided the case under Indiana law.

Claims Not Made Prior to Policy Inception

Liberty argued that coverage under the claims-made D&O policy was excluded because the initial Nassar-related claims were made before the policy period of May 16, 2016 through May 16, 2017. The bankruptcy court, however, agreed with USAG and concluded that Liberty had failed to designate evidence that any claims involving Nassar's sexual abuse were made before the policy period began. First, the Seventh Circuit agreed with USAG that the FBI's actions before the policy period did not amount to a claim under the policy. The relevant policy deemed a claim to be made only once "an Insured receives a written demand, complaint, indictment, notice of charges, or order of formal investigation." The FBI's interview of one athlete twice, at USAG's request, was not any of those things. The panel determined the policy's provisions regarding those terms are expressly defined and do not encompass FBI interviews.

As for the complaints made in the 1990s, the panel agreed with the bankruptcy court that no evidence suggests they constituted claims. Further, the panel stated that, although several athlete lawsuits allege the existence of a claim on "information and belief," allegations based upon information and belief cannot be presented in admissible form.

Wrongful Conduct Exclusion

Like most D&O policies, the Liberty policy excludes insurance coverage for claims brought about or contributed to by fraudulent, dishonest, or criminal conduct. In examining the exclusion, the panel noted the phrase "any Insured" is broad and unambiguous. It concluded Liberty correctly read the "any Insured" language in the wrongful conduct exclusion and the bankruptcy court's recommendation incorrectly found ambiguity in this portion of the policy.

Like many policies, the wrongful conduct exclusion in the Liberty policy, by its express terms, provides the exclusion "shall only apply if it is finally adjudicated that such conduct in fact occurred."

Considering the resolution of Nassar's state criminal sexual abuse cases, the Seventh Circuit noted that Nassar pleaded guilty to and was sentenced on ten counts of first degree criminal sexual conduct. The remaining wrongful conduct was dismissed without prejudice or is subject to a non-prosecution agreement but were not adjudicated. Thus, under the panel's ruling, the wrongful conduct exclusion applied to only the ten counts on which Nassar pleaded guilty—not the remaining Nassar-related claims, as only a small portion of Nassar's wrongful conduct satisfied the wrongful conduct exclusion's "finally adjudicated" clause.

The Seventh Circuit highlighted that the wrongful conduct exclusion prohibited coverage for a "claim" that is "based upon, arising from, or in any way related to" wrongful conduct, provided that conduct is finally adjudicated to have in fact occurred. The phrase "based upon, arising from, or in any way related to" was not defined in the policy. The majority of the panel considered the plain meaning of the phrase. Read in the context of the entire insurance policy, the plain meaning of "based upon, arising from, or in any way related to" includes a logical connection between the claim and the insured's wrongful acts.

According to the majority, this case "is in the grey territory where the policy's broad language becomes ambiguous as applied to these unique facts." Although the insurer has a reasonable argument for excluding coverage of the other victims' claims, the insured also has a reasonable argument for not excluding them. Accordingly, under the general principles of Indiana insurance law—including that ambiguous policy language is construed against the insurer, especially when it comes to policy exclusions—the insured, USAG, prevailed on this point.

On this point, however, Justice Brennan dissented. According to Justice Brennan, court decisions interpreting "related" in insurance policies across a wide variety of contexts support the conclusion that the wrongful conduct exclusion's language is unambiguous and applies to claims "based upon, arising from or in any way related to" Nassar's sexual abuse that was finally adjudicated in his guilty pleas and for which he was sentenced. Justice Brennan would conclude that the wrongful conduct exclusion applied to all the Nassar-related conduct, and thus, would require judgment be entered for Liberty.

Bodily Injury Exclusion

Liberty maintained that the bodily injury exclusion excluded the athlete lawsuits—a subset of the Nassar-related claims—asserted by hundreds of gymnasts seeking to hold USAG responsible for allowing the abuse to take place and causing them to suffer physical, mental, and emotional damage. The policy excludes claims "made against any insured for: (a) bodily injury, sickness, disease, death; or (b) emotional distress, mental anguish ..." But an exception provides that part (b) of the exclusion "shall not apply to any claim brought by or on behalf of any Third Person, or any past, present, or prospective Insured Person for an Employment Practices Wrongful Act." The bankruptcy court held that the bodily injury exclusion did not apply for multiple reasons, including because the exception specifies that the exclusion does not apply to emotional distress claims brought by third parties. The Seventh Circuit reviewed the bankruptcy court's summary judgment decision de novo.

According to the panel, the exception to the bodily injury exclusion requiring coverage for an Employment Practices Wrongful Act was written broadly and should be applied broadly, leaving Liberty with the duty to defend the athlete lawsuits seeking relief for emotional distress and/or mental anguish. Liberty never raised the argument that the exception applies only to third-party emotional distress claims for an Employment Practices Wrongful Act before the bankruptcy court.

Coverage for Investigations

Another disputed issue was whether the policy covered claims for non-compulsory investigations and information gathering that did not specifically allege USAG committed a wrongful act. Two issues comprised this disagreement: whether the Congressional and USOPC investigations were "formal investigations" or "formal proceedings" such that they satisfy the definition of a "claim" under the policy; and whether the White deposition and investigation matters were "for a Wrongful Act." The bankruptcy court ruled that the investigations were formal and therefore claims, but it did not speak to the second issue.

The panel determined that the congressional and USOPC investigations were "formal proceedings" or "formal investigations." The claims made in those proceedings were adversarial, and they raised the specter of misconduct by USAG, resulting in very serious harm to hundreds of girls and women. "Formal" has been defined as "[o]f, relating to, or involving establishing procedural rules, customs, and practices." "Formal" does not have to mean coercive, but instead can refer to the investigation being carried out according to established rules and procedures, which these investigations were. The panel also determined that the various investigations involved wrongful acts.

EPL Sublimit

In addition to an overall liability limit of $5 million, the policy included a $250,000 sublimit endorsement for Third Party Employment Practices Liability ("Third Party EPL"). The bankruptcy court found that the sublimit did not apply because the policy did not define "Third Party EPL" and was ambiguous and without legal effect. The panel, however, agreed with Liberty that "Third Party EPL," although not defined in the policy, is a term of art in the insurance industry. The bankruptcy court incorrected refused to consider evidence offered by Liberty to interpret this endorsement. With this type of insurance term of art, used in a policy in which the parties have a history of negotiating the terms of coverage, parol evidence should be allowed and considered.

Accordingly, the case was reversed and remanded to the district court and bankruptcy court for further proceedings.

USA Gymnastics v. Liberty Insurance Underwriters, Inc., No. 20-1245, 2022 U.S. App. LEXIS 5185 (7th Cir. Feb. 25, 2022).