M&A Objection Lawsuits and Claims for Inadequate Consideration: A "Bumpy" Road for D&O Insurers

By: David J. Creagan and Justin K. Fortescue
Financial Lines Alert
5.26.21

Although the volume of merger objection litigation has gone down somewhat over the last few years, most large public-company M&A deals are challenged in court. These lawsuits usually include a number of claims against the companies involved in the merger/acquisition as well as their respective directors and officers (D&Os). These lawsuits often include allegations that the directors and officers of the acquired company breached their fiduciary duty by failing to maximize shareholder value. And more often than not, these "Bump-Up Claims" are settled for multimillion-dollar payments that give shareholders what they allegedly "should have" received in the first place. For D&O insurers, these lawsuits can result in claims for coverage that, if not handled correctly, can lead to defense and indemnity payouts in the tens of millions of dollars.

The first consideration for D&O insurers is whether Bump-Up Claims are covered under a D&O Policy. At its core, a Bump-Up Claim is typically based on a payment made to shareholders to put them in the position they would have been in had a sufficient price been paid for their stock. So, is that an insurable loss under a D&O Policy? While reasonable minds can (and will) disagree, there may be a few reasons why the answer could (or should) be no.

The first is public policy and the potential moral hazard created by providing coverage to D&Os for Bump-Up Claims. In a merger or acquisition, it is incumbent on the D&Os of the target company to negotiate the best price reasonably possible for the company's shareholders. If, however, D&Os are confident that any shortfall in the amount received will be covered by insurance, they may have incentives to "take a deal" rather than continuing to negotiate a higher price.

Second, there is an open question as to whether the payment of an amount that "should" have been paid to shareholders in the first place is a "Loss" under a D&O Policy. And notably, at least one Court has held that such a payment is not. In *Level 3 Communication v. Federal Ins. Co.,* 272 F.3d 908(7th Circuit 2001), the underlying plaintiffs alleged that Level 3 had made fraudulent representations about the value of the target company's shares, thereby allowing Level 3 to buy the stock at an undervalued price. In effect, Level 3 was accused of having obtained the target company by deception, and the plaintiffs sought to rescind the transaction and recover their shares or at least the monetary value of their shares. Level 3 settled the lawsuits for $11.8 million and sought to recover that amount from its D&O insurers. The D&O insurers argued, among other things, that the $11.8 million was not (capital L) "Loss" but rather restitutionary in character since it represented the amount that Level 3 should have paid to the target company's shareholders in the first place. And the Court agreed, holding that "[a] n insured incurs no loss within the meaning of the insurance contract by being compelled to return property that it had stolen, even if a more polite word than 'stolen' is used to characterize the claim for the property's return." *Id.* at 911. When viewed in this light, one can see why a Bump-Up Claim may not be covered even where the D&O Policy at issue does not contain a Bump-Up Exclusion.

Of course, other courts have rejected this argument, so consideration of the specific D&O policy at issue (and any Bump-Up related provisions therein) will often be necessary to determine whether a Bump-Up Claim is covered. There are a number of different provisions that address Bump-Up Claims with some policies containing an exclusion for Bump-Up Claims while others carve back coverage for Bump-Up Claims from the definition of Loss (collectively referred to as "Bump-Up Provisions"). While the case law addressing these Bump-Up Provisions is somewhat sparse, a few key cases have provided some insight into how courts will interpret them.

In *Genzyme Corp. v. Federal*, 622 F.3d 62 (5th Cir. 2010) for example, the court held that a Bump-Up Provision excluded coverage for the insured's settlement of a class action lawsuit.[1] Genzyme had set up its capital structure to include tracking stocks designed to track the performance of particular divisions rather than the company as a whole. Genzyme invoked a provision in its articles of incorporation under which it was permitted to exchange tracking stocks for regular Genzyme stock at a price equal to 130% of the fair market value of the tracking stocks. The share exchange was unpopular, and several class action lawsuits were filed against Genzyme. These lawsuits included a number of allegations, including that Genzyme's D&Os breached their fiduciary duties by undervaluing the price of the tracking stocks. Ultimately the lawsuits settled for $64 million paid by Genzyme, and the settlement was distributed to shareholders on a pro-rata basis (*i.e.*, each share received a certain dollar amount of the settlement). Genzyme then sought to collect from its D&O carrier the full $10 million limit of its policy and Federal denied the claim based on the Bump-Up Provision.

The Fifth Circuit agreed with Federal and found the Bump-Up Provision precluded coverage. In reaching its decision, the court noted that: (1) Genzyme had acquired the tracking stocks (as part of the stock exchange); (2) the consideration for the exchange was allegedly inadequate; and (3) the allegedly inadequate consideration led Genzyme to make a payment (*i.e.*, a Loss). Lastly, the court rejected Genzyme's argument that Genzyme did not "purchase" any securities. Rather, the Court held that an exchange of shares in the manner completed by Genzyme would commonly be referred to as a purchase (as required by the Bump-Up Provision).

Another case involving a Bump-Up Claim was *Onyx Pharmaceuticals v. Old Republic Co.*, Civ. No. 538248 (Cal. Sup., 2018). In *Onyx*, Amgen Incorporated acquired Onyx in an all-cash transaction whereby Onyx shareholders recovered $125 per share. Plaintiffs (which were Onyx's shareholders) sued Onyx and its Board of Directors for breach of fiduciary duties alleging they failed to maximize the price to be paid to Onyx's shareholders. The lawsuit was settled for $30 million, which was distributed to shareholders on a per share basis. Onyx thereafter sought coverage for the payment under its D&O policy and the carriers denied the claim arguing it was not covered under the policy.[2]

The carriers argued that the policy carved back coverage for loss with respect to payments made for claims alleging that the price paid for the acquisition of the assets of an entity was inadequate. As Onyx was "an entity," the carriers argued the $30 million settlement paid to shareholders represented an increase in the amount of consideration for the sale and was not a loss under the terms of the policy. Onyx, on the other hand, argued that its claim was covered because Onyx did not fall within the term "an entity." To support its argument, Onyx noted that throughout the policy, where the policy meant to refer to Onyx it would use the term "Named Entity" (which was defined as Onyx). Thus, by using the term "any entity" rather than "Named Entity" the policy could not have been referring to Onyx. The court rejected Onyx's argument and held that the Loss Carve Back had the effect of excluding coverage for Onyx's claim.

The most recent case addressing a Bump Up Claim was *Northrup Grumman Innovation Systems v. Zurich Am. Ins. Co.*, No. N18C-09-210, 2021 Del. Super. LEXIS 92 (Feb. 2, 2021). In *Northrup*, Alliant Techsystems and Orbital Sciences Corporation, following various disclosures to stockholders and a proxy vote, completed a reverse triangular stock for stock merger out of which OATK (a new company) was born. After the merger was completed, former Orbital sciences shareholders filed lawsuits against OATK and certain directors of what was formerly Alliant, alleging that the proxy solicitation materials contained false or misleading statements (*i.e.*, that the vote to approve the transaction was based on false pretenses since the value of Alliant was misrepresented). The lawsuits were ultimately settled for over $100 million and OATK, which had been purchased by Northrup, sought coverage for the settlement from its D&O carriers. The carriers denied the claim for a variety of reasons including, as pertinent here, a Loss Carve Back in the policy.[3]

The *Northrup* court sided with the policyholder and held that the Bump Up Provision did not exclude coverage for the settlement. First, the court found that the Bump Up Provision, though phrased as a "carve back from loss" was in fact an exclusion and should therefore be interpreted narrowly. Second, the court held the claims made by the stockholders were not exclusively about "inadequate consideration" but also involved dissemination of a false and misleading proxy statement. Third, the court found that the Bump Up

Provision, by its own terms, only applied to the "acquisition" of another company (*i.e.*, where both companies retain their legal existence after the transaction) and that, because the transaction was a merger, the Bump-Up Provision did not apply. Lastly, and perhaps most importantly, the court found that the settlement did not represent an increase in consideration paid to the shareholders. Rather, the court found that the settlement was to compensate the shareholders for the harm caused by the "overvaluing of Alliant" (*i.e.*, that Orbital gave up too much in the merger with Alliant) and therefore the settlement actually represented a "bump down" not a "bump up."

These cases make clear that Bump-Up Provisions can be effective in precluding coverage for Bump-Up Claims. Whether they will apply to exclude coverage for a specific claim, however, will turn on the particular set of facts and the language used in the Bump-Up Provision. One thing for sure is that given the frequency of lawsuits raising objections to mergers and acquisitions, as well as the fact that most lawsuits are resolved by way of settlement, the issue of whether so called Bump-Up Claims are covered by D&O policies is unlikely to go away anytime soon.

If you have questions or would like additional information, please contact David Creagan (creagand@whiteandwilliams.com; 215.864.7032), Justin K. Fortescue (fortescuej@whiteandwilliams.com; 215.864.6823) or another member of our Reinsurance Group.

---

[1] The Bump Up Provision at issue provided: [Federal] shall not be liable under Insuring Clause 3 for that part of Loss, other than Defense Costs, which is based upon, arising from, or in consequence of the actual or proposed payment by any Insured Organization of allegedly inadequate or excessive consideration in connection with its purchase of securities issued by an Insured Organization.

Id. at 67.

[2] The Bump Up Provision at issue provided: In the event of a Claim alleging that the price or consideration paid or proposed to be paid for the acquisition or completion of the acquisition of all or substantially all of the ownership interest in or assets of an entity is inadequate, Loss with respect to such Claim shall not include any amount of any judgment or settlement representing the amount by which such price or consideration is effectively increased.

[3] The Bump Up Provision at issue provided: In the event of a Claim alleging that the price or consideration paid for the acquisition or completion of the acquisition of all or substantially all the ownership interest or assets in an entity is inadequate, Loss with respect to such Claim shall not include any amount of any judgment or settlement representing the amount by which such price is effectively increased.

Id. at * 10-11.

This correspondence should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes only and you are urged to consult a lawyer concerning your own situation and legal questions.