Maximizing The Return On Your D&O Insurance For Merger Objection Lawsuits

By Peter Gillon and Alex Hardiman

With the explosion of "merger objection" lawsuits being filed by the plaintiffs' securities bar in the last decade, policyholders seeking coverage under their directors' and officers' (D&O) liability insurance for those suits have increasingly been butting heads with their insurance carriers over the application of the "price change exclusion" (also referred to as the "bump-up" exclusion). This has been a major source of frustration for companies reasonably expecting their policies to respond fully to merger objection suits—especially shareholder suits claiming breach of fiduciary duties by the target company's Board of Directors in approving the sale of the target. Many companies and their securities defense counsel have capitulated in the face of their carriers' declinations of coverage. But, as this note explains, it is critical to consult with coverage counsel on these matters as insurers' assertion of the price change exclusion is often misplaced.

Between 2007 and 2014 the percentage of merger and acquisition (M&A) transactions valued at $100 million or more that were challenged by merger objection lawsuits rose from 44% to 93%.[1] These merger objection lawsuits usually are filed as putative class actions on behalf of the shareholders of the company to be acquired (the "target"), often shortly after the announcement of the proposed M&A transaction. The lawsuits typically allege that the terms of the proposed acquisition are unfavorable to shareholders, that the proposed price for the target company is too low, the acquisition process for approving was inadequate, or that the shareholders were provided with misleading or incomplete disclosures about the transaction. The overwhelming majority of merger objection lawsuits have historically been resolved by settlement.[2]

The defendants named in a merger objection lawsuit are usually the target company, its board of directors, and sometimes the acquiring company and its board based on an "aiding and abetting" theory. Although the causes of action and relief requested vary, generally a merger objection lawsuit will contain some or all of the following types of causes of action and requests for relief: (1) violation of sections 14(a) and 20(a) of the Securities Exchange Act based on allegations of material omissions or misrepresentations in the proxy statement filed in connection with the M&A transaction; (2) breach of fiduciary duty based on allegations that the target's directors breached their duties by failing to conduct proper due diligence, make required shareholder disclosures, or obtain an adequate price; and (3) requests for equitable relief in the form of additional disclosures to shareholders, an injunction against the M&A transaction or a change in the price for the transaction.

As the number of merger objection lawsuits has risen, so have the efforts of D&O insurance companies to resist or reduce coverage for those lawsuits. Central to this effort has been insurance companies' reliance on the so-called "bump-up" or price change exclusion in D&O policies. The language of price change exclusions has evolved over recent years, and tends to vary widely from policy to policy. It generally appears as a limitation on the definition of "Loss," even though technically it is drafted as an exclusion, and thus should impose the same burden of proof on the insurer to prove its application. A common version from a leading insurer purports to exclude from the definition of "Loss" the amount of a settlement or judgment "representing the amount by which [the price or consideration paid for the target] is effectively increased":

> 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 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]

This wording reflects a bit of an obfuscation of the language found in earlier forms of the exclusion, which were clearly limited to acquisitions by the insured of an ownership interest in another company, and not to the sale of the insured's own stock. In the above-quoted version, which has yet to be tested judicially, the argument could still be made that by implication it only applies to acquisitions of other companies by the insured, but few insurers accept that view. On the plus side, this version only excludes the amount of the change of price or consideration, and not defense

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1. *Shareholder Litigation Involving Acquisitions of Public Companies - Review of 2014 M&A Litigation,* Cornerstone Research (2015), https://www.cornerstone.com/GetAttachment/897c61ef-bfde-46e6-a2b8-5f94906c6ee2/Shareholder-Litigation-Involving-Acquisitions-2014-Review.pdf
2. *Id.* (noting that historically with respect to merger objection lawsuits resolved prior to close of an M&A transaction, over 90% of such suits were resolved by settlement with the remainder either voluntarily withdrawn by the plaintiffs or dismissed by the courts, and that resolution of post-closing suits was primarily withdrawal or dismissal.)
3. *See* AIG "PortfolioSelect for Public Companies" policy, *http://www.aig.com/Chartis/internet/US/en/PortfolioSelect_for_Public_Companies_Specimen_Policy_tcm3171-533001_tcm3171-543667.pdf*

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costs, plaintiffs' attorneys' fees or other such elements of Loss.

Recently, we have seen insurers assert the price change exclusion as a potential defense to coverage at the most critical moment: just when the litigants are seeking to settle shareholders' breach of fiduciary duty claims against the directors and officers. The result has been to inject several complicating factors into the already difficult process of litigating and settling these claims. One factor is that the exclusion generally does not apply to defense costs, and therefore the insureds may be incentivized to continue litigation—particularly because after the merger closes, the parties in charge of the litigation (the executives of the acquirer), are unlikely to be in the cross-hairs of discovery and unlikely to be as concerned with the burden of litigation as the target's former directors and officers. Another factor is that the exclusion is more pernicious for claims being litigated after the merger closing. Pre-closing, the remedies may include increased disclosures and other non-monetary consideration; whereas, after closing, settlement becomes more difficult, as non-monetary settlement terms are frequently no longer available as settlement tools, and the derivative claims against the directors may be non-indemnifiable, thus escalating the importance of coverage. (As in other derivative claims, Side A DIC coverage may drop down and fill in any coverage gaps.)

Fortunately, policyholders have numerous avenues to challenge insurers' assertion of the price change exclusion with respect to breach of fiduciary duty claims. First, because the exclusion requires that "the [acquisition] price or consideration is effectively increased" to be triggered, the exclusion should not apply unless there has in fact been an increase in the price paid for the acquisition as a result of the merger objection lawsuit. Thus, for example, a settlement of a pre-merger closing suit which consists of increased disclosures and other non-monetary relief, plus plaintiffs' attorneys' fees, would not fall within the exclusion. Similarly, claims based on Sections 14(a) and 20 of the Securities Exchange Act, which typically seek damages for alleged misrepresentations or omissions in a proxy filing, would not implicate the exclusion because they do not seek a change in the acquisition price.

Second, the common version of the exclusion cited above should not apply to damages resulting from an alleged breach of fiduciary duties by the Board. A negotiated lump sum damage settlement does not constitute a change of price. Furthermore, assuming the exclusion applies in the first place to shareholder claims against the insured's Board for sale of the insured's own stock to an acquirer, it is simply not true that the requested relief must effectively be a change of price. For example, the court could rule that the Board's process for approving the merger was totally flawed and unfair to shareholders, resulting in a breach of fiduciary duties, but that the price paid for the company was fair. See, e.g., *Kahn v. Tremont Corp.*, 694 A.2d 422, 432 (Del. 1997).("[H]ere, the process is so intertwined with price that under Weinberger's unitary standard a finding that the price negotiated by the Special Committee might have been fair does not save the result.")

Third, claims alleging wrongdoing by individual directors or officers that are indemnified by the target may fall outside the scope of some versions of the exclusion. Better forms prevent its use against breach of fiduciary claims by limiting the exclusion to claims against the insured organization, thus excepting claims against the Board. See *Genzyme Corp. v. Federal Insur. Co.*, 622 F.3d 62 (1st Cir. 2010) which held that Chubb's exclusion applies by its terms only to the portion of Loss for which the insured entity is liable, not to the portion allocable to Side B indemnification of individual D's and O's by the corporation. Because claims were made against both entity and board, case was remanded to district court for appropriate allocation.

As with all such issues, policyholders are well advised to review their policies and to consult with their counsel about opportunities to improve their policy language to avoid these types of disputes. In some cases, that may require a change of carrier.

To summarize, policyholders should review and seek appropriate clarification if not modification of the "bump up" or price change exclusion in their D&O policies. In our practice, we frequently see carriers attempt to assert the exclusion in inappropriate circumstances. Policyholders should resist insurance company attempts to apply the exclusion beyond its intended or written scope. ■ ■ ■

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the COI holder, and the insurance agent's actual or apparent authority to issue the COI.

When the Insurance Company Is Estopped

Additionally, an insurance company might be estopped from denying coverage on the basis of a COI—although appellate courts in New York are split over this question and so policyholders should investigate the law of their jurisdiction. See *10 Ellicott Square Court Corp. v. Mt. Valley Indem. Co.,* 634 F.3d 112, 122–23 (2d Cir. 2010).

In jurisdictions where an insurance company can be estopped from denying coverage, this outcome is factually specific, and whether the insurer must provide coverage turns on several different factors, including the specific language of the COI, the language of the insurance policy, the detrimental reliance of the recipient on the representations of the party providing the COI, the authority of the party that issued the COI, and the involvement, if any, of the insurance carrier in issuing or approving the COI. For example, in *Bucon Inc. v. Pennsylvania Manufacturing Association Insurance Co.,* 547 N.Y.S.2d 925 (3d Dep't 1989), a subcontractor agreed to add a contractor and the property owner to its insurance policy as additional insureds and to indemnify them against liability arising from its work. An initial COI did not name them as additional insureds,

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