How Courts Are Clarifying D&O Policies' Bump-Up Provisions

By **Andrew Paliotta** (February 13, 2023)

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The U.S. Court of Appeals for the Seventh Circuit's recent decision in Komatsu Mining Corp. v. Columbia Casualty Co. and Travelers Casualty and Surety Co. of America[1] is one of the first appellate decisions on "bump-up" provisions.

The ruling affirms a decision from the U.S. District Court for the Eastern District of Wisconsin, holding that a settlement in connection with various shareholder lawsuits met the definition of "inadequate consideration claim" in a public company directors and officers policy, and did not constitute a covered loss.

Insurers will look to Komatsu in other similar cases in order to support the applicability of these provisions in their D&O policies. But a more telling test may be on the horizon in a pending action before the U.S. Court of Appeals for the Fourth Circuit, Towers Watson & Co. v. National Union Fire Insurance Co.[2]

Bump-Up Provisions

After an M&A transaction, shareholders of the acquired company frequently commence lawsuits alleging that the company and its directors and officers failed to secure adequate consideration for the shares of the company, and seeking to hold the company and its directors and officers liable for what the shareholders argue is the true value of the shares.

A bump-up or inadequate consideration provision in a D&O policy specifically excludes from coverage any payment that could be characterized as an increase, or bump up, in the purchase price of a company.

U.S. Circuit Judge Frank Easterbrook, writing for the Seventh Circuit panel in Komatsu, reasoned that insurers include bump-up provisions in D&O policies to protect themselves from the moral hazard of incentivizing a buyer to underpay in a transaction, with the rest of the true value coming from insurance after the shareholders file suit.

The Komatsu Decision

In 2016, a merger occurred in which the insured, Joy Global Inc., was acquired by another company, Komatsu. In response to the acquisition announcement, shareholders of the insured filed multiple lawsuits against the insured and its directors and officers, alleging that they had issued false or misleading proxy reports to induce them to vote their shares for inadequate consideration.

These eight lawsuits were eventually settled for $21 million. The insured tendered the lawsuits to its D&O insurers, Columbia and Travelers, and sought indemnification for the settlement payment.

The insurers denied coverage for the settlement, concluding that the actions constituted "inadequate consideration claims," which were defined as "that part of any Claim alleging the price or consideration paid or proposed to be paid for the acquisition of all or substantially all of the ownership interest in or assets of an entity is inadequate."

The definition of "loss" in the policies provided that it "shall not include any judgment or settlement of any Inadequate Consideration Claim," and therefore the settlement constituted an exception to covered loss.

The insured argued that the shareholder actions were covered, because they alleged liability on the basis of misrepresentation in proxy statements, not on the basis of inadequate consideration. The Eastern District of Wisconsin rejected that argument, and granted summary judgment in favor of the insurers.

The court found that all the actions alleged that the insured's shareholders received inadequate consideration in the transaction, and that the policy unambiguously excludes the entire settlement where a part of a claim alleged inadequate consideration.[3] The Seventh Circuit affirmed.

Rejecting the insured's arguments on appeal, the Seventh Circuit held that the complaint alleged that the insured failed to reveal that the share price was too low — and by concealing that information, the proxy statements induced shareholders to vote in favor of a merger. The court found that these allegations met the definition of an inadequate consideration claim.

The Seventh Circuit reviewed all the complaints and found the only objection to the merger was that the insured could have, and should have, held out for more money — and that the claims related to the false or deficient disclosures did not depend on anything other than share price.

Like the district court, the Seventh Circuit rejected the holding of a recent Delaware Superior Court case relied on by the insured, Northrop Grumman Innovation Systems Inc. v. Zurich American Insurance Co.[4] The court in that case held that inadequate consideration exclusions apply only when inadequate price is the sole allegation in the underlying complaint, and that the claims under Section 14 of the Securities Exchange Act at issue were not exclusively about inadequate consideration.

The Seventh Circuit panel, led by Judge Easterbrook, asked the insured at oral argument "whether any of the complaints offered a theory of liability that did not depend on a view that the price offered for the Joy Global shares was too low."

According to the decision, the insured pointed to the complaint of inadequate disclosures. But the Seventh Circuit reasoned that the only theory of liability concerning inadequate disclosures was related to inadequate share price, and that therefore, the claims fell within the definition of "inadequate consideration claims."

For that reason, the settlement payment did not constitute covered loss, and the Seventh Circuit affirmed the decision of the lower court in favor of the insurers.

How Komatsu Compares to Other Cases

In what might be one of the most important points in the decision, Judge Easterbrook also reasoned that not all D&O policies contain the same language, and courts should not proceed as if they do. With that, the Seventh Circuit rejected the applicability of Northrop, a decision regularly, and favorably, cited by insureds, including Komatsu.

There are significant distinctions among Komatsu, Northrop and Towers Watson, however.

In Komatsu, the Seventh Circuit was not faced with an argument about whether the structure of the business combination meets the undefined term "acquisition" — an issue in Northrop, as well as in Towers Watson.

In Northrop, the Delaware Superior Court held that the bump-up provision at issue "applie[ed] solely to a special type of transaction: an acquisition of all or substantially all of an entity's assets or ownership." The court further found the business combination in Northrop — a reverse triangular merger — did not meet that requirement, and was, instead, a merger, which was not included in the policy language.

By doing this, the Delaware Superior Court rejected the insurers' arguments that the reverse triangular merger involved an acquisition, and strictly construed the provision against the insurers.

Although the appellate brief filed by Joy Global did not focus on the structure of the business combination, it made a similar argument, asserting that since Joy Global was the selling entity, it did not offer or pay anything, rendering the exclusion inapplicable. Joy Global also asserted that the moral hazard issue is irrelevant to a seller who would seek the highest price.

The Seventh Circuit did not reach that argument, concluding that all other arguments made by the parties "do not require a discussion." One may surmise, however, that the court may have focused on the fact the language of the definition of "inadequate consideration claim" does not specify whether it applies to a buyer or a seller in a transaction.

Thus, the court may have reasoned that the phrase in the definition "the ownership interest in or assets of an entity is inadequate" broadly applies to Joy Global, as either the buyer or the seller in a transaction. Faced with a similar argument and policy language, it is possible that a different court, such as in Delaware, may have found differently.

Undefined terms and the structure of the business combination are also issues in Towers Watson, currently awaiting oral argument in the Fourth Circuit. In 2016, Towers Watson executed a reverse triangular merger with Willis Group, resulting in the issuance of stock in a newly constituted company incorporating the two merged entities, Willis Towers Watson.

Following the merger, shareholders of Towers Watson sued, alleging that material information was concealed, and that the shareholders received "consideration lower than the true value of their shares." The shareholders ultimately settled for $90 million.

The policy provision at issue in Towers Watson provided that loss shall not include "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." The U.S. District Court for the Eastern District of Virginia found that the provision was "clearly an exclusion from coverage," and narrowly construed the language against the insurers.

The court also found that, under the structure of the reverse triangular merger, Willis never actually acquired any of Tower Watson's stock, and reasoned that the complex business combination "was hardly comparable" to the acquisition suggested by the policy provision. In addition, the court rejected the insurers' arguments that the reverse triangular merger involved an acquisition, relying on the holding of Northrop.

The Fourth Circuit will now be tasked with evaluating that same transaction — and also

potentially addressing the insurers' argument that the claim alleged inadequate consideration, an issue never reached below.

The D&O Policy After Komatsu

Komatsu, Northrop and Towers Watson all demonstrate the importance of the particular language of the inadequate consideration provision, which can lead to different results in similar cases.

Although these cases may provide guidance for both insurers and insureds on how to negotiate the drafting of these provisions during the underwriting process — including undefined terms — factual differences in the structures of the specific business combinations at issue may limit the applicability of the decisions in future cases.

Komatsu also demonstrates the Seventh Circuit's willingness to review the underlying claim closely, and not merely rely on the characterizations argued by the parties when evaluating coverage. This decision now provides support for insurers to argue that other courts should do the same.

It will be interesting to see if the Fourth Circuit reaches the question of whether the underlying claim in Towers Watson involved inadequate consideration, or limits the review to the structure of the business combination. Moreover, if it analyzes the inadequate consideration issue, it will also be interesting to see whether the Fourth Circuit finds Komatsu or Northrop to be more persuasive, or whether it develops a completely different analysis of bump-up exclusions.

With Komatsu, and soon, Towers Watson, insureds and insurers are beginning to obtain some appellate guidance on this important issue in D&O insurance.

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[1] Komatsu Mining Corp. v. Columbia Casualty Co. and Travelers Casualty and Surety Co. of America, No. 21-2695, 2023 WL 354732 (7th Circ. Jan. 24, 2023) (applying Wisconsin law).

[2] Towers Watson & Co. v. National Union Fire Insurance Co., 20-cv-810, 2021 WL 4555188 (E.D. Va. Oct. 5, 2021).

[3] Joy Glob. Inc. v. Columbia Cas. Co., 555 F. Supp. 3d 589 (E.D. Wis. 2021).

[4] Northrop Grumman Innovation Systems Inc. v. Zurich American Insurance Co., 2021 Del. Super. LEXIS 92 (Feb. 2, 2021).