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Bumping the Bump-Up Exclusion: A Policyholder's Guide to Resisting Improper Coverage Denials

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Most public-company M&A deals are challenged in court. Commonly referred to as merger objection litigation, these lawsuits typically involve a variety of claims brought by shareholders against the companies and their directors and officers involved in the transaction, including claims under Sections 14(a) and 10(b) of the Securities Exchange Act. Shareholders also assert breach of fiduciary duty claims against the directors and officers under state law.

Policyholders faced with these potential liabilities should be aware that their directors and officers (D&O) liability insurance companies may deny coverage based on the so-called "bump-up" or "inadequate consideration" exclusion ("the bump-up exclusion" or "the exclusion"). Insurance companies routinely and reflexively argue that the bump-up exclusion precludes coverage for any lawsuit following a corporate merger or similar transaction in which a settlement payment or judgment could be characterized as an increase (a "bump-up") of the price paid for a target company.

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In our experience, however, insurance companies interpret the bump-up exclusion far too broadly and beyond the insurance industry's purported intent behind the exclusion. D&O policyholders should be prepared to resist such coverage denials.

The History of the Bump-Up Exclusion

The bump-up exclusion varies from policy to policy but generally is found in the definition of "loss" in the D&O liability insurance policy. A common version of the exclusion states:

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 …; provided, however, that this paragraph shall not apply to Defense Costs or to any Non-Indemnifiable Loss in connection therewith.

Northrop Grumman Innovation Sys. v. Zurich Am. Ins. Co., No. CV N18C-09-210, 2021 WL 347015, at *3 (Del. Super. Ct. Feb. 2, 2021).

National Union Insurance Co. developed the first bump-up exclusion in 1995 in response to the U.S. Court of Appeals for the Ninth Circuit's decision in *Safeway Stores v. National Union Fire Insurance*, 64 F.3d 1282 (9th Cir. 1995). In *Safeway*, the seller in a leveraged-buyout transaction (Safeway) settled lawsuits brought by its shareholders by shifting the timing of an $11.5 million stock dividend so that the dividend would be paid earlier and therefore paid to its shareholders as opposed to the shareholders of the buyer company (Kohlberg Kravis Roberts & Co.). The seller then sought insurance coverage for the payment of the $11.5 million stock dividend under its D&O liability insurance policy.

The Ninth Circuit held that "the settlement did not—and could not—result in [a] … loss" to the seller and therefore was not covered under its D&O policy for two reasons. First, the seller "was obliged to pay out the dividend in due course, with or without the settlement." Second, the court explained that the early payment of the dividend to the selling shareholders "essentially amounted to [the buyer's] upping its purchase price for [the seller] by [the dividend amount]." Thus, the court found that "the dividend, if a 'loss' to anyone, was [the buyer's]."

Although the seller was denied coverage, the Ninth Circuit's observation that the buyer suffered a loss raised concern in the insurance industry. Under *Safeway*'s rationale, insurance companies became concerned that a buyer in a corporate transaction could pay an unfairly low price for the acquisition of another company and then use its D&O insurance proceeds to supplement the purchase price by settling lawsuits brought by the selling shareholders. Thus, the insurance industry introduced the "bump-up" exclusion for "bump-up" payments or price-based claims.

Courts Have Limited the Application of the Bump-Up Exclusion

Despite the narrow and well-understood intent of the bump-up exclusion, as merger objection lawsuits have continued in number and frequency, insurance companies have sought to stretch its application to a variety of circumstances beyond even the insurance industry's purported intent.

Thankfully, a number of courts have rejected these attempts. Below, we discuss some of the limitations of the bump-up exclusion recognized by the courts.

Price-Based Claims Against Buyers vs. Claims Against Sellers

Insurance companies have argued that the bump-up exclusion precludes coverage for lawsuits against the seller company and its directors and officers following a corporate merger. As discussed above, however, when the insurance industry introduced the exclusion into the market, the industry intended to exclude from covered loss *price-based* claims against the *buyer* in a corporate transaction.

That intent is demonstrated not only by the history of the bump-up exclusion, but it also is expressly set forth in the plain language of the exclusion.

First, it focuses on excluding coverage for allegations where the payment of an inadequate purchase price is the act that gives rise to liability and where the policyholder seeks payment of "loss" attributable to such allegations. Specifically, the exclusion purports to exclude from the definition of covered "loss" that "amount of any judgment or settlement of" a "claim alleging that the price paid for an acquisition of an entity is inadequate" where that amount "represents an increase in the amount paid."

The bump-up exclusion cannot apply to claims against the seller company since the seller does not pay for its own acquisition and therefore cannot give rise to the liability—that is, the wrongful act—the exclusion purports to exclude.

In addition, the bump-up exclusion applies only to claims involving the "acquisition of … *an entity*" – a term that is not defined in D&O liability insurance policies. However, D&O insurance policies expressly refer to and define the seller as the named insured of the insured entity (or some similar defined term)—usually hundreds of times.

Because it is an exclusion, the bump-up exclusion must be interpreted narrowly. The seller therefore cannot, by default, fall within the generic term "an entity," particularly since the D&O policies define the seller in other instances and since the exclusion speaks about actions taken by the buyer in a corporation transaction.

Indeed, at least one court previously considered and rejected an insurance company's attempt to use the bump-up exclusion to deny coverage for a claim brought against a target company where the bump-up exclusion reasonably could be read as applying only where the policyholder is the acquirer.

In *Gardner Denver v. Arch Insurance*, No. CIV.A. 16-0159, 2016 WL 7324646 (E.D. Pa. Dec. 16, 2016), the court held that the bump-up exclusion, which applied to the "purchase of securities or assets of a Corporation[,]" did not clearly apply to the insured target company because of the policy's use of the article "a" before the term "corporation." Even though the policy defined "corporation" as the insured target company, the court held that a "reasonable person could construe the use of the phrase 'a corporation' as meaning an entity other than [the insured target company]."

Accordingly, the court denied the insurance companies' motion to dismiss and rejected their argument that the bump-up exclusion "unambiguously exclude[d] coverage" in that case.

This interpretation of the bump-up exclusion makes perfect sense, since the exclusion provides that "Loss … shall not include any amount of any judgment or settlement representing the amount by which such price" – that is, "the price or consideration *paid*"—"is effectively increased …" By definition, damages in an action against a target company or its directors and officers cannot reflect an increase in the price of consideration *paid* because target companies have paid no consideration in the first place.

Acquisition vs. Merger

Policyholders also should pay attention to the type of corporate transaction at issue. Insurance companies reflexively assert the bump-up exclusion following a corporate merger or similar transaction. However, the exclusion applies only to the "*acquisition* of all or substantially all of an entity's assets or ownership" – and nothing else. Thus, for the insurance company to meet its burden of proving that the bump-up exclusion applies, it must demonstrate that the corporate transaction at issue unambiguously is an *acquisition*.

Not all corporate transactions are acquisitions though. Indeed, many of these corporate transactions are mergers.

Several courts have rejected insurance companies' attempts to apply the bump-up exclusion to corporate transactions that are not acquisitions. For example, in *Viacom v. U.S. Specialty Insurance*, No. N22C-06-016 SKR CCLD, 2023 WL 5224690, at *1 (Del. Super. Ct. Aug. 10, 2023), the Delaware Superior Court held that the insurance companies incorrectly applied the exclusion to a corporate merger, in which the target company did not survive. The court explained:

Here, the contract is ambiguous. On one hand, a merger may be "an acquisition of all or substantially all ownership interest in, or assets of, an entity," because all assets of [the target "vest[ed] in" [the buyer], and [the buyer] was the surviving corporation. On the other hand, "an acquisition of all or substantially all ownership interest in, or assets of, an entity" may be exclusive of merger transactions based on the reference to mergers in other provisions of the contract. Both interpretations are reasonable, and though two contrary, reasonable interpretations are generally sufficient to defeat a motion for summary judgment, here, any ambiguity is interpreted in favor of the insured.

Similarly, in *Northrop Grumman*, the Delaware Superior Court held that the bump-up exclusion did not apply because the corporate transaction at issue was a merger, not an acquisition. Noting that the insurance industry drafted the exclusion so that it "applies solely to a special type of transaction: an acquisition of all or substantially all of an entity's assets or ownership," the court held that it could not apply.

Importantly, the *Northrup Grumman* court correctly declined to act as the insurance industry's post-loss underwriter, explaining that "[i]f the Policies were intended to exclude all transaction-based [c]laims … then their drafters could have written them that way."

Partial vs. Total Exclusion

Courts also have recognized the extremely limited scope of the bump-up exclusion regarding the type of loss it purports to exclude. Insurance companies routinely argue that the exclusion applies to exclude insurance coverage for *all* damages sought in an underlying lawsuit whenever a portion of the alleged damages could be characterized as an increase of the price paid for a target company.

The bump-up exclusion is *not* a total exclusion, however. Even where it is triggered, it purports to exclude underlying claims that seek damages that "represent[ ] the amount by which such price is effectively increased."

Merger objection lawsuits, however, often seek various types of relief and damages that may not be characterized as "representing" an increase in purchase price.

For example, in *Northrop Grumman*, the plaintiff shareholders asserted a claim under Section 14(a) of the Securities Exchange Act, which alleged that the dissemination of allegedly false proxy statements "induced [shareholders] to vote their shares" in a merger when they otherwise would not have. The court explained the bump-up exclusion does not apply to this type of claim because it the exclusion "pushes out Loss *only* that 'represent[s]' an 'effective[ ] increase[ ]' of the claimant's inadequate consideration; no other Loss will do." By contrast, a Section 14(a) claim not "exclusively about … inadequate consideration," but rather, also is about whether the stockholders were "induc[ed] … to vote their shares when they otherwise wouldn't have."

Thus, the court correctly held that such a "federal securities class action about fabricated proxy forms is not the narrowly tailored fit th[e] [bump-up] Exclusion imagined." Policyholders therefore should pay close attention to the types of damages sought when contesting the insurance industry's application of the bump-up exclusion.

Exclusion

Insurance companies also have argued that the bump-up exclusion is not an exclusion at all, asserting that it is a coverage provision that the policyholder bears the burden of proving.

Thankfully, courts (including the *Viacom* court) have widely rejected that argument as well, finding that it is in fact an exclusion, for which the insurance company carries the burden of proof.

Defense Costs and Difficult Decisions

Under most D&O policy forms, the bump-up exclusion does not apply to the policyholder's defense costs. Although this is very helpful to the company and its directors and officers, it raises difficult decisions about when and how to resolve claims.

An insurance company's refusal to settle a claim will continue defense costs expenditure and erode policy limits that otherwise could be used to pay for a settlement or judgment. At a minimum, the insurance company has a duty to settle claims reasonably and fairly, and that duty includes an obligation to act promptly. "By refusing to settle within the policy limits, an insurer risks being charged with bad faith on the premise that it has advanced its own interests by compromising those of its insured." *Pavia v. State Farm Mut. Auto. Ins.*, 82 N.Y.2d 445, 452 (1993) (internal quotation marks and citation omitted).

Conclusion

Policyholder directors, officers and corporations should be prepared for a few bumps in the night. Companies and their directors and officers involved in such corporate mergers should be prepared to resist coverage denials improperly based on the bump-up exclusion, or other improper coverage-avoidance exclusions popular in D&O insurance company claims departments.

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