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Expert Analysis

District Court Narrowly Construes Bump-Up Exclusion in Merger

By **Howard B. Epstein**

And **Theodore A. Keyes**

With the increase in mergers and acquisitions activity in the market over the last year or so, companies and practitioners have also seen an inevitable increase in related litigation. Such litigation often includes lawsuits filed by shareholders of an acquired entity seeking damages for alleged breaches of duty by board members and in some cases claiming that the acquisition consideration was inadequate.

Many directors and officers (D&O) insurance policies contain what is known as a bump-up exclusion, which is generally intended to preclude coverage for loss that represents the amount by which the acquisition price or consideration is increased as a result of these claims. Although referred to and treated as an exclusion, the relevant bump-up terms most often appear, not as an independent exclusion, but as a carve-out to the definition of loss in the D&O policy.

Despite its potential significance, there have been surprisingly few court decisions interpreting the scope or application of the exclusion, the specific terms of which may vary from policy to policy. Consequently, any court opinion analyzing the application of a bump-up exclusion should be considered as it may provide guidance and persuasive authority for future insurance disputes.

On Oct. 5, 2021, the U.S. District Court for the Eastern District of Virginia issued a Memorandum Opinion and Order narrowly construing the bump-up exclusion in favor of the insured in a dispute related to the merger of two leading insurance brokers, Towers Watson and Willis. *Towers Watson & Co. v. National Union Fire Ins. Co.*, Case No. 1:20-cv-810, 2021 WL 4555188 (E.D. Va. Oct. 5, 2021).

The Willis and Towers Watson Merger

The merger of Willis and Towers Watson was billed as a "merger of equals" with Willis Towers Watson emerging as the go-forward entity. According to the Court, the transaction included several complicated steps starting with a merger between Towers Watson and a merger sub created by Willis, with Towers Watson emerging as the surviving corporation and as a subsidiary of Willis. Next, to simplify and summarize, Towers Watson's common stock was cancelled, it was delisted on the NASDAQ, deregistered under the Exchange Act and Towers Watson shareholders received a certificate entitling them to 2.6490 shares of Willis stock for each share of Towers Watson cancelled common stock. Towers Watson was then merged into an existing Willis subsidiary and ceased to exist. Finally, once all of the steps were completed, the former Towers Watson shareholders owned 49.9% of Willis Towers Watson, controlled six of the 12 board seats and the former CEO of Towers Watson took over as CEO of Willis Towers Watson.

The Underlying Class Action Claims

The insurance dispute concerned two separate underlying actions related to the merger, a class action filed in Virginia and a consolidated action filed in Delaware. The Virginia class action alleged violations of §§14(a) and 20(a) of the Securities and Exchange Act of 1934 in connection with the proxy material distributed in

HOWARD B. EPSTEIN *is a partner at Schulte Roth & Zabel.* THEODORE A. KEYES *is special counsel at the firm.*

advance of the merger. The Virginia plaintiffs alleged a failure to disclose pre-merger discussions involving the Towers Watson CEO concerning his compensation package and claimed that proper disclosure of these discussions would have resulted in an increase in the consideration received by the Towers Watson shareholders.

The Delaware consolidated shareholders' derivative action included allegations of breaches of fiduciary duty and aiding and abetting breaches of fiduciary duty against the Towers Watson CEO and other actors based on facts similar to those alleged in the Virginia action.

The Virginia and Delaware class actions were settled for a combined $90 million, $75 million for the Virginia class and $15 million for the Delaware claimants and the settlements were approved by the Virginia and Delaware courts.

The Dispute Over The Bump-Up Exclusion

Upon receipt of the notices of claim, the defendant insurers acknowledged that the Virginia and Delaware actions constituted claims within the meaning of the insurance policies and agreed to advance defense costs incurred to defend those actions. The insurers, however, denied coverage for any settlement or judgment excluded from the policy definition of loss by the bump-up exclusion. When presented with the settlements, the insurers contended that coverage was barred by the bump-up exclusion, which provided as follows:

> In the event of any 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; provided, however, that this paragraph shall not apply to Defense Costs or to any Non-Indemnifiable Loss in connection therewith.

Towers Watson & Co. v. National Union Fire Ins. Co., 2021 WL 4555188 at *2.

After the insurers denied coverage, Towers Watson filed a lawsuit against the insurers and moved for partial summary judgment seeking a declaration that the settlements paid to resolve the Virginia and Delaware actions were covered and not excluded by the bump-up exclusion.

> Although referred to and treated as an exclusion, the relevant bump-up terms most often appear, not as an independent exclusion, but as a carve-out to the definition of loss in the D&O policy.

The District Court's Ruling

Like other courts that have recently considered the issue, the District Court determined that, even though it is included within the definition of loss in the policy, the bump-up exclusion is to be treated like an exclusion. See also *Onyx Pharm v. Old Republic Ins.*, No. CIV 538248, 2020 WL 9889619 at *7 (Cal. Super. Oct. 1, 2020); *Northrop Grumman Innovation Sys. v. Zurich Am. Ins. Co.*, No. CV N18C-09-210, 2021 WL 347015, at *9 (Del. Super. Ct. March 1, 2021), cert. denied, 2021 WL 772312 (Del. Super Ct. March 1, 2021). Under Virginia law, as well as the law of most states, that means the bump-up exclusion must be construed narrowly.

As a result, the court described the dispositive issue as whether the bump-up exclusion unambiguously applies or whether there is a reasonable construction of the exclusion that makes it inapplicable to the Virginia and Delaware settlements. The court identified three potentially determinative questions based on the specific language of the exclusion:

> (i) was the merger "the acquisition … of all or substantially all the ownership interest in … an entity"
> (ii) were the underlying actions a "Claim alleging that the price or consideration paid … for the acquisition … is inadequate"
> (iii) were the settlements an "amount … representing the amount by which such price or consideration [for "the acquisition"] is effectively increased"

Towers Watson & Co. v. National Union Fire Ins. Co., 2021 WL 4555188 at *8.

To resolve Towers Watson's motion, the court did not have to look beyond the first question, as it determined that the bump-up exclusion did not unambiguously apply to the merger based on the "Policy's language, the specific structure and overall result of the transaction that resulted in the Merger, and how the referenced acquisition and a transaction like the Merger are viewed under Delaware corporate law." Id. at 9. Following review of these factors, the court determined that the Willis-Towers Watson merger was not necessarily an "acquisition" within the meaning of the bump-up exclusion.

The Merger Was Not Necessarily an Acquisition

In reviewing the specific policy language, the court found it significant that "acquisition" was not a defined policy term and that it was modified in the bump-up exclusion by the phrase "of all or substantially all the ownership interest in or assets of any entity." The court indicated that the type of acquisition referenced in the bump-up exclusion is commonly associated with a transaction where one company takes over another company, as opposed to a merger in which two entities are combined into a single entity with shared ownership by the stockholders of the merging entities. In addition, the court noted that the policy definition of "Transaction" included three different types of transactions, one of which would be considered an acquisition as described in the bump-up exclusion and one of which would be considered a merger—suggesting that this provided further support for narrowly construing the type of transactions to which the bump-up exclusion is applicable.

The court also focused on the specifics of the actual transaction, emphasizing that Willis never actually acquired any of the stock formerly owned by the Towers Watson shareholders. Instead, that stock was cancelled, the Towers Watson shareholders received a Certificate that entitled them to Willis shares and, upon completion of the merger, Towers Watson shareholders owned 49.9% of Willis Towers Watson and controlled 6 of the 12 board seats. The court determined that, "[u]nder these circumstances, the Merger was hardly comparable to the straightforward takeover of one company by another suggested by the Bump-Up Exclusion and therefore is reasonably viewed as something other than 'the acquisition' referenced in the Bump-Up Exclusion." Id. at 10.

Finally, the court also relied on Delaware corporate law which, the court explained, treats a merger as a distinct type of transaction with accompanying procedural requirements and substantive law consequences that differentiate it from other types of acquisition techniques involving stock or asset transfers. According to the court, while an acquisition and a merger may not be mutually exclusive, a takeover acquisition and a merger have distinct meanings under Delaware law. The court also rejected the insurers' arguments that relied on the accounting and tax treatment of the merger.

The District Court determined that under the narrow construction it was required to apply to the bump-up exclusion, it was reasonable to read the exclusion as inapplicable to the Willis-Towers Watson merger because it was not necessarily an acquisition as that term is used in the bump-up exclusion.

In sum, the District Court determined that under the narrow construction it was required to apply to the bump-up exclusion, it was reasonable to read the exclusion as inapplicable to the Willis-Towers Watson merger because it was not necessarily an acquisition as that term is used in the bump-up exclusion.

Looking Forward

It would probably be a mistake to presume that the District Court's ruling is the last word on bump-up exclusions or even on the application of the exclusion to the Willis-Towers Watson merger. Given the settlement amounts at stake, an insurer appeal of the ruling seems likely. Further, due to the lack of court decisions interpreting the bump-up exclusion, it is reasonable to anticipate that similar disputes will arise in connection with other transaction-related litigation—many of which may involve differences in policy language or governing law as well as unique transaction details.

While the *Towers Watson* ruling is policyholder friendly, the court's analysis is instructive because it sets forth in reasonable detail the issues that insurers and policyholders will need to be prepared to address in future disputes involving bump-up exclusions. It also highlights for policyholders the importance of reviewing their D&O policy terms so that the application of a bump-up exclusion in connection with acquisition-related claims does not come as a surprise.

Schulte Roth&Zabel

Schulte Roth & Zabel LLP
919 Third Avenue, New York, NY 10022
212.756.2000 tel | 212.593.5955 fax | www.srz.com
New York | Washington DC | London