By: Kevin M. LaCroix

The D&O Diary

A Periodic Journal Containing Items of Interest From the World of Directors & Officers Liability, With Occasional Commentary

“Inadequate Consideration” Exclusion Precludes Coverage for Underpayment of Insured Company’s Acquisition

By Kevin LaCroix on January 29, 2023

For the second time in recent days, a court has held that a D&O insurance policy provision operates to preclude coverage for claims against an insured company and its executives that the consideration to be paid *for the acquisition of the insured company* is inadequate. The Seventh Circuit in a recent decision held that the “inadequate consideration” exclusion (sometimes referred to as the “bump-up” exclusion) in the applicable D&O insurance precludes coverage for a claim that disclosure in the company’s proxy statement omitted information that could have been used to negotiate a higher price. As discussed below, the policy wording at issue was relevant to the outcome. The Seventh Circuit’s January 23, 2023, opinion in the Komatsu Mining Corp. case can be found **here**.

Background

In July 2016, Joy Global and Komatsu America Corp. agreed to merge. Shareholders of Joy Global filed an action against the company and certain of its directors and officers alleging that the defendants had violated Section 14 of the Securities Exchange Act of 1934 by failing to disclose internal Joy Global future growth projections that the plaintiffs alleged could have been used to negotiate a price higher than the one Joy Global agreed to accept. The shareholders also alleged that Joy Global's directors violated their duties as a matter of state law by not maximizing the price shareholders stood to receive. The shareholder litigation ultimately settled for $21 million. The proposed merger was approved and completed, with Komatsu as the surviving company.

Joy Global sought to have its D&O insurers pay the cost of the settlement of the shareholder action. The insurers declined to pay, based on the Inadequate Consideration Claim exclusion. Komatsu, as Joy Global's successor in interest, initiated a coverage lawsuit against the insurers. The district court, applying Wisconsin law, granted the insurers' motion for summary judgment, holding that the policy's Inadequate Consideration Claim exclusion precluded coverage.

Relevant Policy Language

The Inadequate Claim exclusion precludes coverage for "any amount of any judgment or settlement of any Inadequate Consideration Claim other than Defense Costs." The term "Inadequate Consideration Claim" is defined as "that part 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."

The January 23, 2023 Opinion

On January 23, 2023, the Seventh Circuit, in a terse opinion written by Judge Frank Easterbrook for a unanimous three-judge panel, and applying Wisconsin law, affirmed the district court's summary judgment grant.

Judge Easterbrook began his analysis of the coverage issues by considering why an insurance policy might exclude coverage for "inadequate consideration." He noted that of course bidders might want to try to shift part of the cost of acquisition to a third party. Insurers, seeking to avoid getting stuck making up the shortfall of lowball bids, use "clauses about inadequate consideration to protect themselves from this moral hazard." The exclusion means that the bidder, "not the insurer, pays the target's full market value."

Judge Easterbrook then addressed Komatsu's argument that the underlying suit could not have been about inadequate consideration, because the shareholders' claim was pressed under Section 14; federal law claims, Komatsu argued, relate to disclosure, while state law claims address

remedies about prices (for example, through appraisal actions). The underlying claim included both a federal and a state law claim. Judge Easterbrook observed that "the federal claim was asserting inadequate disclosure, and the state claim was the directors' asserted breach of their duty of care, but the loss from any legal wrong depended on a conclusion that the price offered in the merger was too low."

Judge Easterbrook noted further that in oral argument, Komatsu's lawyer had argued that the federal claim depended on inadequate disclosures. But, Judge Easterbrook asked, "did it depend on false or deficient disclosures about anything other than prices?" Counsel, Judge Easterbrook said, did not identify any part of the complaint making such a claim, and "our own review did not turn one up." The only objection to this merger, Judge Easterbrook observed, was that "Joy Global could and should have held out for more money, and that revealing this would have induced the investors to vote 'no' (or file suit in state court) and so trigger a renegotiation of the price."

In reaching this conclusion, the Seventh Circuit, like the district court below in this coverage dispute, declined to follow a 2021 Delaware Superior Court decision, applying Delaware law, holding that an inadequate consideration exclusion applies only when inadequate price is the sole allegation in the underlying complaint, and that any other type of allegation (including insufficient disclosure) nullifies the exclusion. The appellate court declined to follow this authority, noting that it applied Delaware rather than Wisconsin law, and noting further that the language of the exclusion at issue in the Delaware case differed from the language at issue in the exclusion at issue in this case. Judge Easterbrook added that "Komatsu Mining wants us to proceed as if all D&O policies contain the same language, but they don't, so we shouldn't."

Discussion

The appellate ruling in this case, holding that the inadequate consideration exclusion applied to preclude coverage, follows close on the heels after the post-trial ruling in the Onyx case, which I discussed recently in detail **here**, and which also held that a "bump up" exclusion at issue in that case applied to preclude coverage. Though the two coverage decisions reached similar rulings based on similar policy provisions, there are quite a few differences between the rulings.

For starters, the Onyx decision reflected the extensive testimony at trial on how the applicable exclusion came to be in the policy at issue, and whether or not there were alternatives policies available in the marketplace that alternative exclusionary wording that would not have precluded the claim. The Onyx decision also reflected extensive trial testimony about the origins, purpose, and meaning of the exclusion. The appellate decision in the Komatsu case, reviewing the lower

court's summary judgment ruling, had none of the dramatic trial testimony reflected in the Onyx decision – yet the two cases reached a similar conclusion based on related policy provisions.

The two rulings are similar in that the exclusions in both cases were interpreted to apply even where the insured company was the target company. As I noted in my recent discussion of the Onyx decision, inadequate consideration exclusions (or bump up exclusions) in many D&O insurance policies apply only if the insured company is the acquiror, but do not by their terms apply when the insured company is, as was the case here, the target company. In that regard it is noteworthy in the policy at issue here that when the policy defined the term "inadequate consideration claim," the definition provided that it applied when the price to be paid for the acquisition of "the ownership interest in or assets of an entity" is inadequate. It is noteworthy here that the reference here is to the ownership interest or assets of "an entity," and not of "an Entity" or of "the Entity." The lower-case "e" on the word entity suggests that the exclusion applies regardless of whether the insured company is the acquiror or the target.

Judge Easterbrook's analysis of the purposes of the inadequate consideration exclusion arguably implies that the exclusionary purposes of the provision apply regardless of the acquisition target – the insurer should not be made a third-party payor to make up the shortfall of a low-ball acquisition bid.

However, as the court emphasized in the Onyx case, there are alternatives available in the marketplace where the exclusion applies only if the insured company is the acquiror. The argument should be made that when the insured company is the acquiror that the purposes of the exclusion are particularly apt; that is, the insured company itself cannot low ball a bid and then have its insurer act as a third-party payor to make up the shortfall. The circumstances arguably are different if the insured company is the *target* and the acquisition price is argued to be too low; there, the allegation is that the company's shareholders are receiving inadequate consideration as a result of wrongdoing by officials of the insured company.

In any event, there is no doubt that from the perspective of the insured company, exclusionary language that only applies if the insured company is the acquiror and does not apply of the insured company is the target is clearly preferred. More to the point, an exclusion that preserves coverage when the insured company is the acquisition target preserves coverage for claims that the company's executives committed wrongful acts, which is the purpose for which the coverage exists.

The D&O Diary

Copyright ©2023, Kevin M. LaCroix. All Rights Reserved.