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Beating bump-up exclusions: Policyholder prevails in coverage for settlement of M&A shareholder lawsuit

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A Delaware court recently refused to enforce a directors and officers liability policy's "bump-up" exclusion to a $28 million class action settlement, finding that the company's insurers unjustifiably denied coverage. The decision, which is one of several recent bump-up D&O coverage disputes, provides valuable insights for corporate policyholders seeking coverage for M&A-related claims and settlements with shareholders.

Background

In connection with the sale of Harman International in 2017, a class of Harman stockholders filed a securities class action lawsuit alleging that disclosures made in connection with the sale were misleading and violated Section 14(a) and Section 20(a) of the Securities Exchange Act of 1934 (the "Baum action"). The Baum action was settled for $28 million.

The parties disagreed on whether the transaction, which was structured as a reverse triangle merger, was an "acquisition" potentially within the bump-up provision.

When Harman's D&O liability insurers denied coverage under the policies' so-called "bump-up" exclusion, the company sued for breach of contract and sought a declaratory judgment that the settlement was covered in full by the policies.

Bump-up exclusions are frequently found in D&O insurance policies. While the wording varies among policies, bump-up provisions bar coverage for settlements or judgments in deal-related litigation where the "loss" constitutes an increase (i.e., a bump-up) in the purchase price of the company.

While insurers may agree to defend insureds against alleged wrongful acts in negotiating or approving the deal, they will not effectively fund the purchase price of the acquired company.

In the Harman transaction, the insurers rejected the claim by invoking the bump-up exclusion, which barred coverage for all claims alleging that the price "paid for the acquisition … of all or substantially all of the ownership interest in or assets of an entity is inadequate" and where the loss "represent[s] the amount by which such price or consideration is effectively increased."

Because the *Baum* action demanded the difference in price the shareholders received and the true value at the time of the acquisition, the insurers argued the settlement was excluded from coverage.

The court's analysis

In a January 3 opinion, the Delaware Superior Court agreed with Harman and held that the insurers had wrongfully denied coverage for the settlement.[1]

In deciding that the bump-up exclusion did not apply, the court focused on three elements of the exclusion: (1) whether the settlement related to an underlying "acquisition"; (2) whether "inadequate deal price" was a viable remedy sought in the underlying litigation; and (3) whether the settlement represented an effective increase in transaction consideration.

The insurers carried the burden to show that all elements were satisfied.

The nature of the transaction. The parties disagreed on whether the transaction, which was structured as a reverse triangle merger, was an "acquisition" potentially within the bump-up provision.

The court determined that the Harman transaction was an "acquisition" because, among other reasons, the transaction resulted in the buyer owning 100% of Harman, which was in effect an acquisition. Other factors, like Harman's post-transaction legal status and cancellation of Harman's shares, also supported Harmon being acquired.

Finally, the court pointed to Harman's own Form 8-K filed with the Securities and Exchange Commission, which described the transaction as an "acquisition." The court found that these factors, taken together, made the transaction an "acquisition" as such term was used in the bump-up exclusion.

The viability of alleged damages. Harman contended that the settlement could not constitute an increase in inadequate deal consideration because a Section 14(a) claim can't be used to obtain damages for inadequate consideration.

The insurers disagreed, contending that the settlement had to represent an increase in deal price because the *Baum* complaint expressly sought damages equal to the difference between Harman's true value and the price paid to the shareholders when the transaction closed.

The court examined the settlement and concluded it did not represent an increase in the deal price.

The court acknowledged that the *Baum* action alleged inadequate consideration, but the court emphasized that damages for an undervalued deal were not a viable remedy under Sections 14(a) and 20(a) of the Securities Exchange Act of 1934. Rather, the court said those claims focus on the accuracy of the proxy statement's disclosures and did not raise any claims authorizing the court to remedy an inadequate deal price.

The purpose of the settlement. Lastly, the court examined the settlement and concluded it did not represent an increase in the deal price. The insurers contended that the settlement resulted in an increase in consideration because the settlement amount was based in part on the alleged fair value of Harman stock compared to what Harman shareholders actually received.

Harman argued that the settlement represented only the value of legal expenses that it avoided by not litigating. The court looked no further than the agreement itself, which denied liability and stated the sole purpose of the settlement was to avoid litigation.

The $28 million settlement price closely resembled the estimated legal fees and was not in line with the potential increased deal consideration, which the court estimated would be over $279 million. Therefore, the court concluded that the Baum settlement did not constitute an adjustment of the consideration offered to Harman's stockholders to complete the acquisition.

Discussion

The *Harman* decision has several takeaways for policyholders.

Deals driving D&O disputes. As insurers continue to test the limits of these exclusions, bump-up disputes continue to make headlines and drive high-value, contentious coverage litigation for deal-related D&O claims. The *Harman* decision is the latest example of judges grappling with enforcement of bump-up language in different scenarios, including other cases in Delaware, which have had varying outcomes for policyholders.

The recent win is significant, especially for policyholders incorporated in Delaware that may be more inclined to pursue coverage litigation in the First State where the Delaware Supreme Court has stated that Delaware law should apply (https://bit.ly/4bKxwUo) to disputes over D&O policies sold to Delaware companies.

Insurers have high burdens. The decision reinforces the difficult burden that insurers should face in proving that a loss fits within a bump-up exclusion, especially in the context of a settlement rather than judicial decision on the merits.

The court resolved the dispute through the "norm" that a bump-up exclusion is "construed narrowly" and that any ambiguity must be interpreted in favor of coverage. And a bump-up provision should apply only "if the settlement clearly declares that its purpose is to remedy inadequate consideration given in an acquisition."

While the *Harman* court felt that this standard was "beyond debate," not all courts interpreting similar exclusionary provisions have been so clear in holding insurers to this burden, so it will surely be a welcome reminder for policyholders assessing deal-related D&O claims.

Allegations, even of inadequate consideration, are not dispositive. The insurers cited allegations of an "undervalued" acquisition resulting in damages calculated as "the difference between the price Harman shareholders received and Harman's true value at the time of the Acquisition." But the court more closely followed the language of the bump-up exclusion.

Policyholders need to understand whether their D&O policy has problematic exclusionary language and, if so, whether to address it before pursuing an M&A transaction.

The provision required not just that plaintiffs alleged inadequate consideration in the deal but that the loss "represent" an effective increase in consideration. The court only looked to the complaint to assess whether inadequate consideration was a viable remedy under the theories of liability alleged.

Because cured inadequate deal price wasn't available for Section 14(a) and Section 20(a) securities claims, the plaintiff's "bare request" for relief for inadequate price was not enough. This will be welcome to policyholders because stockholder-plaintiffs routinely assert a variety of theories and purported damages in M&A litigation which should not necessarily dictate the nature of the settlement.

Consider insurance early and often. The decision provides a roadmap of key issues for policyholders to consider when thinking about potential coverage in deal-related litigation. It starts with the structure of the deal itself, which here was a reverse triangular merger that Harman argued did not fit within the exclusion's applicability to "acquisitions."

While the court did not accept that position, it pointed to a statement in Harman's Form 8-K calling the deal an "acquisition" to suggest that the company in some sense understood it to be an acquisition.

More importantly, the court emphasized two aspects of the settlement agreement itself in determining the nature of the settlement: an express denial by the policyholder of any wrongdoing or liability; and statements that the reason for the settlement was "solely" to avoid protracted and expensive litigation and that it would be "beneficial to avoid costs, uncertainty, and risks" inherent in such litigation. This was not necessarily dispositive to the case.

Given the lack of evidence from the insurers that might show the settlement was an effective increase in merger consideration, it may not have mattered if the settlement agreement read differently. But when faced with evidence that the settlement represented the estimated litigation costs, the court declined to speculate and rejected the insurers' bump-up defense.

Conclusion

The *Harman* decision shows the continued importance of bump-up exclusions and how they can lead to coverage disputes in deal-related litigation. Policyholders need to understand whether their D&O policy has problematic exclusionary language and, if so, whether to address it before pursuing an M&A transaction. The decision also provides guidance for settlement strategies that may maximize coverage.

Notes:

[1] *Harman International Industries Inc. v. Illinois National Insurance Co.*, No. N22C-05-098, 2025 WL 84702 (Del. Super. Ct. Jan. 3, 2025).

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