D&O Coverage Litigation for Securities Appraisal Actions

By: Robert D. Allen[1]
The Allen Law Group
Dallas, Texas
bob.allen@theallenlaw.com

January 29, 2019

In the context of a merger or acquisition, Delaware General Corporation Law §262 ("Delaware §262") provides an equitable remedy that allows shareholders of a publicly held company being acquired to dissent to the so-called "deal price" in the merger and it appoints the Delaware Chancery Court to appraise the value of their stock shares. Other states also have similar securities appraisal statutes. *See, e.g.,* Kansas Statutes Annotated 17-6712. Under Delaware §262, dissenting shareholders receive the appraised value of their stock, as determined by the Chancery Court, which could be lower, higher or the same as the merger price. Additionally, Delaware §262 appraisal petitioners can recover annual interest at 5% over the federal discount rate compounded quarterly from the date of the merger until the appraisal action concludes.

Obtaining a return of 5% annual interest compounded quarterly over a very low federal discount rate has attracted enterprising and sophisticated investors to dissent to mergers and institute Delaware §262 appraisal actions.[2] In some instances, the Delaware §262 appraisal petitioners have reaped enormous profits from their Delaware §262 appraisal actions resulting from an increase in the stock share price, plus the statutory interest. In other instances, the dissenting shareholders have made significant money on the statutory interest alone; even when the Chancery Court determines that the fair value of the stock is less than the merger price. Accordingly for certain investors and their litigation counsel, Delaware §262 appraisal actions can be a highly lucrative litigation opportunity.

With this background, since 2016, at least three acquired companies that litigated securities appraisal proceedings to eventual settlements have brought coverage actions against their Directors and Officers ("D&O") insurers to recover their costs of defending the securities appraisal actions

[1] Bob Allen, until recently, was involved in one of the Securities Appraisal Action D&O coverage actions noted in this casenote, in which he monitored the other actions. This casenote reports on the main arguments asserted in the securities appraisal action D&O coverage litigation, but it does not comment on the merits of those arguments. The supporting legal authority is available online from the briefing in the profiled cases.

[2] Some of these Delaware §262 appraisal action petitioners are arbitrageurs who do not purchase their stock in the to-be-acquired company until after upcoming merger plans are announced.

and in two of the cases, the Delaware §262 statutory interest components of the settlements as well.[3] The issue of first impression raised in these cases is whether the settlement of and the attorneys fees incurred in defending a securities appraisal proceeding are covered under the acquired company's D&O insurance policies. These claims involve significant amounts of money. For example, in *Zale v. Liberty,* Zale is seeking over $30 million in coverage. In *Solera Holdings v. XL*, Solera Holdings is seeking over $50 million in coverage.

In *Zale v. Liberty,* Zale Corporation ("Zale") filed suit against the insurers in its D&O coverage tower to obtain coverage for its $34.2 million settlement and over $6 million in attorneys fees and other costs incurred in defending Delaware §262 appraisal actions emanating from the corporate merger of Zale into Signet Jewelers Ltd. ("Signet") in 2014. For the Zale-Signet merger, the Delaware §262 annual interest rate was calculated at 5.75%. The settlement agreement did not allocate what portion of the settlement was attributable to an increase in the price of petitioners shares of Zale stock and what portion of the settlement was attributable to Delaware §262 statutory interest. By reference, 5.75% annual interest compounded quarterly for the 15 months between the date of the Zale-Signet merger and the settlement of the Delaware §262 appraisal actions on the approximately $181 million in merger consideration for Delaware §262 appraisal petitioners shares of Zale stock is $13.1 million

Currently, *Zale v. Liberty* is in the middle of discovery. Of great interest to D&O insurers, policyholders and the D&O coverage bar will be the parties' dispositive motions, which are currently due in mid-March 2019. Meanwhile, *Solera Holdings v. XL* has only recently been filed and it has not yet progressed to any discovery or motion practice.[4]

On the one hand, Zale is taking the position that the Delaware §262 appraisal actions filed against it invokes its D&O policies Securities Action Liability coverage insuring agreement because they involve claims for wrongful acts. On the other hand, the insurers counter that Delaware §262 appraisal actions do not involve a wrongful act; but even if they do, they are excluded from the definition of loss due to the operative policy's "bump-up" exclusion.[5]

---

[3] The initial securities appraisal action D&O coverage litigation was *CEC Entertainment, Inc. v. Travelers Cas. & Sur. Co. of Am.,* Civil Action No. 3:16-cv-02493 at one time on file in the United States District Court for the Northern District of Texas, Dallas Division, which involved the Kansas securities appraisal statute. CEC Entertainment only sought its attorneys fees and expenses incurred in defending the Kansas appraisal actions and it did not seek D&O coverage for an interest component of the appraisal action settlement. *CEC Entertainment v. Travelers* settled while competing motions for summary judgment were pending. *Zale Delaware, Inc. v. Liberty Insurance Underwriters, Inc., et. al.,* Cause No. DC-17-09200 is currently on file in the 14th Judicial District Court of Dallas County, Texas ("*Zale v. Liberty"*); and *Solera Holdings, Inc. v XL Specialty Ins. Co.,* Case No. N18C-315 AML, was recently filed in the Superior Court of the State of Delaware.

[4] *Solera Holdings v. XL* is an example of a Delaware §262 appraisal action resulting in a lower share price than the merger price. There, the merger share price was $55.85. Although Solera Holdings incurred $13.5 million defending the Delaware §262 appraisal action, the Delaware Chancery Court found that the fair value of the merger share price was actually $53.95, almost $2 a share less than the merger price. After this finding by the Delaware Chancery Court, the parties agreed that the Delaware §262 statutory interest was valued at $38 million and then they settled the Delaware §262 appraisal action.

[5] The parties are also raising other claims and defenses, which are not addressed in this casenote. For example, Zale is asserting that the Delaware §262 appraisal actions were interrelated wrongful acts to a covered shareholder fiduciary claim (which Zale won on summary judgment) and it is seeking extracontractual damages. The insurers are also claiming that the Delaware §262 appraisal settlement constitutes uninsurable restitution and by virtue of the timing of

I. Do securities appraisal actions involve a wrongful act?

The issue of whether appraisal actions involve a wrongful act will be front and center in the upcoming summary judgment motion practice in *Zale v. Liberty.* Meanwhile, this issue was the focus of two sets of dispositive motion briefing and two lengthy court hearings presided over by Northern District of Texas Chief Judge Barbara Lynn in the now-settled *CEC Entertainment v. Travelers* litigation.

CEC Entertainment argued that the definition of "wrongful act," which includes "any actual or alleged error, misstatement, misleading statement, act, omission, neglect or breach of duty, actually or allegedly committed by the Insured Persons," encompassed CEC Entertainment's decision to agree to merge at an allegedly inadequate share price. In this regard, CEC Entertainment argued that pursuant to its definition, a "wrongful act" need only be an "act" and it does not have to be wrongful to satisfy the definition. CEC Entertainment also argued that although a securities appraisal action remedy is equitable, the decision process involved in agreeing to a low merger price is wrongful anyway because the shareholders launched the appraisal action based on what they believed to be the improper valuation of their shares. "Absent this allegedly unfair valuation, no appraisal action would have been brought in connection with the merger and cancellation of their shares."

Travelers; however, argued that "[t]he only conduct of CEC that has any relation to the appraisal action was the merger itself, which is neither wrongful nor improper and does not constitute a wrongful act." The argument continues that the nature of the acquired company's conduct is irrelevant because securities appraisal statutes do not require bad conduct or unfairness and they do not consider whether any wrongdoing occurred. Rather, D&O insurers argue that securities appraisal actions are no-fault accounting exercises. According to Travelers, "[b]ecause the appraisal action was not brought against CEC 'for a wrongful act' by CEC, it does not constitute a claim or a securities claim as defined in the policy."

In analyzing whether a "wrongful act" must be wrongful during the motion for summary judgment hearing, Judge Lynn recounted a presentation at a federal court judicial conference by the late U.S. Supreme Court Justice Antonin Scalia and Dallas based legal writing scholar Bryan Garner. As part of their program, they discussed the Latin doctrine *noscitur a sociis*, i.e., "a word is known by the company its keeps." According to the Texas Supreme Court, the purpose of *noscitur a sociis* is "to avoid ascribing to one word a meaning so broad that it is inconsistent with its accompanying words." At the hearing, Judge Lynn wondered aloud about the potential applicability of the doctrine, however, in light of the settlement, it was never decided.

II. Does the bump-up exclusion negate coverage for securities appraisal actions?

Another issue in *Zale v. Liberty* and *Solera Holdings v. XL* Delaware involves whether the appraisal action settlements constitute a "Loss" due to the operative policies' bump-up exclusion. The bump-up exclusion at issue in *Zale v. Liberty* in pertinent part provides:

---

the merger, it is excluded by the run-off endorsement. Additionally, the insurers are raising improper notice and lack of consent to settle.

> With respect to any Claim alleging that the price or consideration paid … for the acquisition of any securities issued … by any … entity is inadequate …, Loss shall not include the portion of any … settlement relating to the amount by which such price or consideration was changed or modified as a result of such Claim; however, this exclusion will not apply to Defense Costs.

Zale takes the position that the bump-up exclusion only pertains to the portion of the settlement related to the change in the share price and it does not apply to Delaware §262 statutory interest component of the settlement or the costs involved in defending the Delaware §262 appraisal actions. Zale next argues that since the timing of the settlement of the Delaware §262 appraisal actions limited the amount of Delaware §262 statutory interest and defense costs that it otherwise would incur, the $34.2 million settlement of the Delaware §262 appraisal actions should be weighted heavier on the Delaware §262 statutory interest and defense costs than the simple mathematical calculation of the interest and the actual amount of the defense costs incurred. Zale also argues that since the Delaware §262 appraisal petitioners also agreed to release their claims on a covered fiduciary action, part of the $34.2 million settlement should be allocated to that covered claim.

Zale's insurers counter that the $34.2 million settlement figure was arrived at by increasing the share price from the merger price of $21 a share to $24.90 a share. Thus, they argue that the settlement is entirely attributable to a change in the share price. The insurers also contest Zale's position that due to its timing, the settlement should be weighted in favor of statutory interest and attorneys fees. Additionally, the insurers contend whatever amount of the settlement is attributable to Delaware §262 statutory interest, that amount still relates to the change of the share price. Accordingly, the insurers argue that the entire settlement is excluded by the bump-up exclusion.

III. What lies ahead for D&O coverage litigation for securities appraisal actions?

Studies show a steady increase in Delaware §262 appraisal actions from 2012 (when 20 were filed) to 2016 (when 48 were filed). In 2016, however, Delaware §262 was amended to provide a safe harbor to companies being acquired that provides relief with respect to the amount of Delaware §262 statutory interest. A Harvard Law School study indicates that the 2016 amendments resulted in a 33% decrease in the filing of Delaware §262 appraisal actions in 2017; although many Delaware §262 appraisal actions continue to be filed.

So far, three securities appraisal action settlements have resulted in lawsuits seeking coverage on the acquired company's D&O policies. No express case law guidance on the coverage issues has yet to emerge from this litigation. It remains to be seen whether D&O coverage litigation for securities appraisal actions will continue, increase or whether after the current lawsuits run their course, they go away.