Path-Dependent Derivatives

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Retained by Sherman & Sterling

In a case involving derivative contracts issued by a firm in an acquisition, attorneys retained Cornerstone Research and Professor William Silber of New York University. As part of the consideration in its mergers with two target firms, the acquiring firm issued two types of derivatives to the target shareholders. These derivatives can be broadly categorized as put options—they decline in value as the price of the underlying stock increases. The plaintiffs alleged that the acquiring firm inflated its stock price after the mergers, thereby reducing the value of the derivatives.

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In his report, Professor Silber demonstrated that a majority of the derivatives were adequately hedged by positions in other securities issued by the acquirer and that such hedged holders suffered no harm from alleged inflation in the acquirer’s stock price. Further, those holders who were not hedged could not form a class as they were in direct conflict with each other regarding the amount of alleged inflation in the acquirer’s stock price. Professor Silber showed that such a conflict arose because of the differences in the contractual terms of the two derivatives—over certain ranges of the acquiring firm’s stock price, an increase in inflation would decrease the value of one derivative but increase the value of the other.