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Client Alert

Insurance Coverage & Recovery Practice Group

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Insurance Checklist for Mergers & Acquisitions: What Every Executive Should Know

Record levels of cash on company balance sheets, cheap financing, and the elimination of political uncertainty following the November presidential election have led many analysts to predict an uptick in M&A activity in the near future. If your company expects to acquire (or be acquired by) another company, it is critical to conduct a review of insurance for the buyer and the seller early in the process. The true cost of a transaction may be much higher than anticipated if liabilities emerge post-sale that are not covered by adequate insurance. This alert outlines key insurance issues a company should address, and due diligence steps it should take, as it approaches a merger or acquisition.

Do Your Insurance Due Diligence

To guard against the risk of inadvertently acquiring uninsured liabilities, the due diligence process must include a focused assessment of the seller's liability exposures and insurance coverage. Important steps include:

- Determine the seller's potential uninsured liabilities following a careful review of the seller's insurance policies and claims history.
- Chart the seller's current and historic insurance policies to ensure the key risks are covered, the primary and excess limits are adequate and unimpaired from other claims, and the insurers are solvent.
- Review the seller's key contracts for risk transfer provisions that may have promised indemnification or conferred additional insured status on the seller's suppliers, customers, or past or present corporate affiliates, as these provisions may place the seller's insurance assets at risk. Similarly, review key contracts to uncover indemnities or insurance that may be available to the seller from other parties.
- Identify new exposures when acquiring new operations in unfamiliar locations, and determine whether new coverages should be purchased or schedules to buyer's existing commercial property policies should be updated to ensure target operations are covered in the event of a catastrophic loss.

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- Ensure all known claims and circumstances that may give rise to claims potentially covered by the seller's policies are reported to the seller's insurers before closing.

- Identify any differences between your company's internal systems for reporting claims and/or circumstances and those of the seller and integrate the two systems as soon as possible after closing.

If your due diligence reveals substantial potential uncovered liabilities, (1) the purchase price can be reduced, and/or (2) the seller can promise to indemnify the buyer.

Insure Risks Arising from the Deal Through Representations and Warranties Insurance

A transaction may generate liability risks such as errors, inaccuracies, or omissions in the purchaser's or seller's representations and warranties that could result in substantial post-closing liabilities, particularly in transactions involving a competitive auction bid process, a divestiture, a financially distressed company, or the acquisition of a closely-held corporation. Some of these risks may fall between the cracks of typical business lines of insurance. Where current policies will not provide coverage for these potential liabilities, and parties are unable to negotiate indemnification or escrow arrangements to allocate these risks, parties can consider Representations and Warranties Insurance and other specialty lines to fill the gaps:

> For the Buyer: Coverage for breaches of representations or warranties for which the seller would have a contractual duty to indemnify the buyer under the terms of the deal.
>
> For the Seller: Coverage for claims made by the buyer for the seller's breach of, or inaccuracy of, a representation or warranty in the transaction agreement.
>
> For Both Buyer and Seller: (1) Coverage for loss arising from a proceeding alleging that the transaction was fraudulent and therefore void; (2) Coverage for an action by a tax authority (*e.g.*, the IRS) alleging the insured asserted an invalid tax treatment for the deal.

Representation and warranty insurance also can be tailored to address specific risks that may otherwise bring a negotiation to a standstill. Given the complex insurance issues in any merger or acquisition, companies should work closely with their risk manager, broker, and experienced outside coverage counsel early in the due diligence process to avoid taking on material uninsured risks and to consider insurance for risks generated by the deal.

Be Sure the Buyer Inherits the Seller's Coverage in an Asset Purchase

When one company acquires another by *merger*, the law in most states provides that the rights and obligations of the acquired company under its insurance policies transfer automatically to the acquirer. This allows the acquired company's policies to cover the acquirer for claims arising from the acquired company's pre-closing actions.

In an *asset sale*, in contrast, several state court decisions, *e.g.*, *Henkel Corp. v. Hartford Accident & Indemnity Co*. (Cal. 2003), hold that the seller's rights and obligations, including its insurance coverage, do not transfer to the buyer. The *Henkel* rule can create coverage gaps if the buyer contractually agrees to take on the seller's pre-closing liabilities, while the insurance for those liabilities does not follow. To avoid such a transfer of uninsured risks, the buyer should have the seller assign its pre-closing insurance policies to the buyer, which usually requires prior consent of the insurers. Carefully review the transaction documents and the seller's insurance policies to avoid the unintentional transfer of liabilities that do not carry their insurance protections with them.

Determine if D&O "Run-Off" or "Tail" Coverage is Needed

D&O policies provide "claims-made" insurance that covers only lawsuits, investigations, or other claims brought against the insured during the policy period. This time limitation could, under certain circumstances, leave the Ds and Os of the seller without adequate coverage for claims that can be filed years after the seller's policy expires (such as fraud claims that may be filed by stockholders up to five years later under Sarbanes-Oxley). It also can leave the seller bare for its indemnification obligations to individual Ds and Os.

To fill these gaps, "run-off" or "tail" insurance extends D&O coverage for a specific number of years for claims arising solely from pre-acquisition wrongful acts of the Ds and Os of the acquired entity. Because run-off insurance does not reinstate the expiring policy's limit, a fresh limit should be negotiated if prior claims have eroded the limit of the expiring policy. Run-off insurance, if needed, should be secured before the transaction closes. The use of tail coverage also assures dedicated limits to the acquired entity's Ds and Os for pre-transaction wrongful actions and likewise gives the combined company comfort that its limits will not be eroded by pre-transaction acts of the acquired company.

Scrutinize "Change in Control" Provisions in the Seller's D&O Policy

D&O, Fiduciary Liability, and some other policies contain "Change in Control" provisions that are triggered by a merger or asset sale. Most such policies state that in the event of a change in control, the policy will remain in force for the remainder of the policy period, but coverage will be provided only for claims involving wrongful acts occurring prior to the change in control. Some policies terminate altogether if there is a change in control. When preparing for an acquisition, it is very important to know precisely how your specific policy will respond in such a situation, and to structure the acquired company's run-off coverage and the surviving entity's coverage accordingly.

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Given the insurance pitfalls of an M&A transaction, companies approaching a merger or acquisition should work with experienced insurance coverage counsel to assist with key insurance due diligence to avoid saddling the company and executives with uninsured liabilities.

King & Spalding lawyers work closely with our clients and their risk managers to address risks arising out of M&A transactions, ensure their insurance affords adequate protection in the event of claims, and assist in recovering from their insurers for any losses.