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Avoiding M&A Insurance Landmines

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M&A deals have small issues, big issues…and "landmine" issues: issues that can seem small but, if mishandled, can end up being significant. Regardless of whether your company is seeking to merge with another company or is looking to acquire or be acquired, here are several key insurance risk management factors worth considering prior to the drafting of a merger agreement.

D&O INSURANCE AND OTHER "CLAIMS-MADE" POLICIES: RUN-OFF COVERAGE & TAIL POLICIES

Whenever a company is acquired, and in certain other merger scenarios, a company's Directors and Officers liability insurance program can go into automatic "run-off." This means that between the closing of the deal and the end of the policy term, the D&O insurance program will only respond to claims that relate to acts that took place before the closing date. At the end of the policy term, the policy will terminate—leaving the Ds and Os with no insurance should they be sued after the insurance program ends.

The solution to this potential gap in coverage is the purchase of a "tail" policy ("tail policy" and "run-off program" are sometimes interchangeable terms in the insurance industry). When a tail policy is purchased, the insurance carriers on the seller's D&O insurance program agree to hold open the insurance policy for an additional period of time. In the United States, six years is the standard time period for a D&O insurance tail policy. This purchase ensures that there will be an insurance policy in place to protect the seller's directors and officers if a claim is brought against them post-closing. Indeed, most sellers will choose to purchase a D&O tail even if the buyer agrees to fully indemnify the Ds and Os of the seller post-close. The buyer may want to make this purchase to insure its own indemnification obligations to the acquired company's Ds and Os. After all, the buyer's own D&O insurance program will not pay for claims related to pre-close activities of the Ds and Os of the seller. Prudent sellers will want to purchase a tail policy to avoid (1) being dependent on what can feel like the whim of a future, perhaps hostile, set of decision makers (management or the board of directors of the buyer at a future time), and (2) making an out of pocket payment should the buyer slip into insolvency before or even at just the moment the seller's directors and officers need to be indemnified.

Most M&A transactions will call for the purchase of a tail policy for the directors and officers of any entity experiencing a change of control. A tail policy generally is non-cancelable, thereby ensuring that the seller's former directors and officers do not run the risk of the acquiring company cancelling the tail policy. By comparison, even if the seller's former Ds and Os were to be added to the buyer's insurance program in a way that would respond to claims related to pre-closing activities, there is no guarantee the buyer will keep its D&O program in place in the future.

Here are some of the critical issues that are relevant to placing tail coverage:

- **Premium.** Tail coverage should be marketed to a number of carriers to drive competition on price and terms. Absent competition, it is possible to pay above-market prices (especially if the carrier decides to view the placement of the tail policy as the last opportunity to generate premium). Similarly, publishing an overly generous D&O tail budget in a publicly disclosed document like a public company's Sale and Purchase Agreement is not the best idea, as doing so might lead an insurance carrier to regard the top of the range as the price to quote. Also, due to the constantly changing nature of the D&O insurance market, even the most experienced M&A attorneys could inadvertently draft problematic tail terms in a seller's definitive merger agreement. *We strongly recommend that Woodruff-Sawyer review the draft agreement to ensure that the insurance language is both accurate and realistic.*

- **Continuity.** Because of the "claims-made" nature of D&O policies, continuity of coverage is always important. Continuity considerations are most important when the target company has pending litigation or attracts litigation pre-closing. Post-announcement, pre-close suits are exceedingly common in any merger or acquisition. The surest way to obtain continuity is to place tail coverage with the incumbent carrier. It is, however, possible for a skilled broker to place tail coverage with a new carrier. Among the issues that come into play should a seller elect this strategy are: the policy's prior acts and prior notice language; whether a warranty statement is required; and whether a specific claim exclusion or prior litigation exclusion is added to the tail policy. Basic differences in the base forms' definitions and terms must also be reviewed to guard against gaps in coverage. Continuity challenges can differ with each tail negotiation. *Woodruff-Sawyer will offer creative solutions to address these challenges.*

- **Litigation and Impaired Aggregate Limit of Liability.** Litigation has the potential to negatively impact a tail policy. If there is open litigation pre-closing, a new aggregate limit of liability should be placed wherever possible, as opposed to extending the aggregate limit of the pre-closing program. Furthermore, based on the specifics of the outstanding litigation, it may be prudent to amend the prior notice exclusion for directors and officers in order to preserve individual coverage for any new claims that may arise out of old litigation. *Woodruff-Sawyer will conduct a thorough review of all outstanding litigation to ensure that the tail policy is structured in a way to address the potential impact of the litigation.*

- **Insured versus Insured Exclusion.** D&O policies typically contain an Insured versus Insured ("IvI") exclusion. In the M&A context, it is important to review the IvI language to make sure that the D&O policy will not exclude claims brought by the acquiring company against the target company's directors and officers. The IvI exclusion can be particularly problematic if a seller's former management is only covered by the buyer's current D&O program in lieu of a tail policy, and the buyer later sues the seller's directors and officers. Even in a tail policy, it is important to watch for problematic variations of the IvI exclusion. *Woodruff-Sawyer can review the structure of the M&A transaction and work with a program to minimize or avoid problematic exclusions.*

- **Sharing Limits with the Entity.** D&O policies generally include coverage for the corporate entity if there is a securities claim. In such a case, directors and officers share the aggregate limit of liability available under the policy with the corporate entity. Post-merger, sharing of limits may not be attractive. In some cases a tail policy should be amended to remove coverage for the entity in favor allocating the entire limit solely to the directors and officers (called "A-Side" coverage because Insuring Clause A provides coverage for directors and officers when there is no indemnification available). Separate A-Side coverage might also be purchased. *Woodruff-Sawyer can work with both buyers and sellers to ensure that all parties understand the strategic trade-offs that result from various tail policy structures.*

- **Retentions.** D&O policies contain certain retentions (i.e., deductibles) that apply depending upon whether indemnification for the directors and officers is available. While the retention is $0 when indemnification is not available, retention amounts can be quite high where indemnification is available. In some cases, a tail policy should be amended to specifically address the retention as it relates to claims brought against the directors and officers post-merger. *Woodruff-Sawyer will work with a seller's existing D&O insurance program to take advantage of any and all term improvements that may have become available between the last renewal and the closing of the M&A transaction.*

While these are some of the more common issues, each tail policy placement is different and should be carefully analyzed with Woodruff-Sawyer and your legal counsel.

It is also important to note that, although a D&O tail may be required in a merger agreement, a tail can be purchased for any type of claims made policy (ex. employment practices, fiduciary liability, errors & omissions). *Woodruff-Sawyer will analyze these policies and provide recommendations based on your unique circumstances.*

P&C INSURANCE ISSUES, INCLUDING WORKERS COMPENSATION

Buyers should be sure to understand the entire scope of a seller's insurance risk management program, including Workers Compensation. A gap-analysis can be a useful way to identify any problems that should be addressed before a deal closes. Both buyers and sellers will want to analyze the scope of any on-going insurance risk management obligations, including financial obligations with respect to Workers Compensation. In some cases, additional insurance may be purchased pre-closing. As noted above, all claims-made policies should be analyzed to determine whether a tail policy should be purchased.

REPRESENTATIONS & WARRANTIES COVERAGE

One significant area of negotiation in any M&A transaction is the representations and warranties that one party will provide to the other. Questions concerning the representations and warranties such as by whom, about what, escrow size, and duration can be complex. Unresolved issues regarding representations & warranties have been known to stop a deal in its tracks.

Representations and Warranties coverage, an M&A-related insurance product, can be a way to overcome what is otherwise an intractable impediment to a deal. These types of polices are triggered by a demand for financial restitution based on a breach of one of the warranties given by a seller in the Sale and Purchase Agreement. These policies are individually tailored to each deal and can be written so that either a buyer or seller is the insured. *Woodruff-Sawyer can work with either buyers or sellers to determine whether an M&A insurance policy would be a helpful addition to the overall M&A transaction process.*

M&A deals by their nature can be a big win for a buyer...that can turn into an enormous loss in the absence of appropriate diligence. For sellers, a great deal can turn into a terrible one if a seller's directors and officers are left uninsured or otherwise over-exposed after a deal closes. Contact your Woodruff-Sawyer representative to discuss your specific deal.

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