Sold! Close Your M&A Deal Confidently By Funding Post-Closing Liabilities Through Insurance

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When a company merges with another entity and becomes a single entity, or where a company is acquired by another organization, it is critical that both parties understand their insurance programs to ensure that transactional risks are properly covered. Companies sometimes do not give adequate consideration to the possibility of future claims following a merger or sale, and do not place into the deal a funding mechanism for post-closing claims. This article offers some ideas to consider when planning an insurance solution to such claims as part of due diligence.

Tail policies cover actions taken before the closing

If you sit on the board of a company, the completion of an M&A deal does not insulate you from being sued for actions you took on behalf of the seller before it was acquired. A once-celebrated M&A deal might become a nightmare for former directors and officers long after a merger or acquisition closes. Directors' and officers' (D&O) "tail" or "run-off" insurance can help provide coverage to a selling company's board members for pre-closing conduct for years following the closing of an M&A deal. D&O insurance is particularly important to a company's senior executives because it covers management and, at times, the corporation from claims made against them arising from the performance of their corporate duties. D&O insurance is written on a "claims made" basis. This means it covers claims asserted against the policyholder and reported to the insurer during the policy period, based on allegedly wrongful conduct occurring while the policy was in effect. A D&O policy can extend coverage for current claims arising from pre-policy wrongful acts back into the past, via a carefully delineated "retroactive date." So if a lawsuit is filed against a director or officer in 2017 concerning acts that happened in 2013, a 2017 D&O policy with a retroactive date of January 1, 2013, would respond to the claim. A gap in coverage can follow a merger or acquisition if the seller's D&O policy expires at closing, and the closing is the retroactive date for the buyer's D&O policy. D&O insurers generally are not willing to cover post-closing claims based on pre-closing activities over which its insureds have no control, so buying past-acts D&O coverage from the buyer's carrier usually is not an option. But the D&O policy for the seller, which does control pre-closing conduct, often includes a provision allowing the seller to purchase an extended discovery period (sometimes called a "tail" or run-off policy) bridging the gap by covering post-closing claims against the seller's directors and officers based on their pre-closing activities. The length of the tail policy can be subject to negotiation to meet or exceed the statutes of limitations for claims that arise out of a merger or sale, such as negligent or intentional misrepresentation. Run-off policy extension premiums are typically issued on a non-refundable, non-cancellable basis. This prohibits third parties from

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trying to challenge or cancel the tail coverage and deprive former executives of the selling company of their insurance protection. The buying company may not assume the seller entity's duty to indemnify claims against directors and officers arising from pre-closing acts, so the purchase of a tail policy is an important term of the deal to which the parties must agree. Another important feature of a run-off policy is that it be available to respond to a post-closing claim by the buyer against the seller's directors and officers for misstatements of fact made during due diligence. If such D&O tail coverage – without an exclusion of claims by the buyer against the seller's directors and officers – is unavailable, an M&A policy may be the only alternative available to cover buyer losses caused by misstatements by the seller. (More about this kind of coverage below.) Almost universally, publicly owned companies have D&O insurance in place when a change of control or ownership occurs. This is the policy to which the tail is attached, which becomes effective at the time of the closing. Directors and officers of a selling company may well intend their D&O insurance to serve in the nature of a hold-back for post-closing claims by the buyer for misrepresentations in connection with the sale, and may well show this intent by having their broker buy the best tail coverage available. Yet D&O coverage usually is not purchased solely to protect value in a transaction – at least not overtly. The same often cannot be said for privately held companies. Private companies do not always have D&O coverage. A private company may decide to buy D&O insurance for the first time during negotiation of a merger or sale. Underwriters may be uncomfortable writing a new D&O policy under these circumstances. A selling company will want to have its insurance broker place the tail policy. Although this broker is about to lose a client, he or she is in the best position to secure the best terms and limits of liability for a tail policy favorable to the seller's directors and officers with whom the broker has relationships and to whom the broker is loyal. Management should resist any suggestion that the buyer's broker place the coverage because this person is loyal to the buyer. Representations and warranties policies are critical A standard feature of most M&A transactions is that the parties make certain representations of fact to one another – called "representations and warranties" – on which they rely to price and close the deal. Representations and warranties insurance (RWI) is written specifically to cover losses arising from unintentional and/or unknown breaches of representations and warranties made by the parties to the transaction. RWI may be used to fund indemnification obligations arising from such breaches. While RWI is available to buyers and sellers alike, the great majority of RWI policies purchased in the United States are buy-side policies. A buy-side RWI policy provides a buyer with coverage in the event of a misstatement or misrepresentation of fact made by the seller in the course of the deal. A buy-side policy is purchased by the buyer and provides first-party coverage which allows the buyer to seek recovery directly from the insurer for losses arising from a seller's breach of its representations and warranties. It allows a buyer to avoid making claims against officers of a merged-out or acquired company who may remain in key management roles. Buy-side coverage also allows a buyer to avoid the disruption of its normal business operations that results from an indemnification claim. Moreover, a prospective buyer may employ RWI as a hedge against the risk of mispricing the deal to distinguish itself from other buyers in a competitive bidding situation. RWI is issued on a claims-made basis, and does not cover breaches of representations and warranties where the breach is known to exist prior to the inception of the policy. (However, buy-side RWI should cover undisclosed breaches known by the seller.) RWI may be structured to cover specific representations and warranties within the purchase and sale agreement, or it may provide blanket coverage.

Buyer should inherit seller's insurance coverage

Insurance policies often contain anti-assignment clauses which prohibit the assignment of the policies, or rights under the policies, without the consent of the insurer. As a general matter, a merged-out or acquired company's rights under its insurance policies often automatically vest in the surviving company by operation of the relevant state merger statute, notwithstanding the anti-assignment provisions of any policy. In the absence of a statutory merger however, courts are divided regarding whether anti-assignment provisions are enforceable. The majority rule holds that post-loss assignments of insurance rights are permitted without consent of the insurer, despite the existence of an anti-assignment clause. The minority rule is that post-loss insurance rights cannot be transferred without insurer consent where the claim is not yet liquidated, i.e., not yet due under the policy or not yet reduced to a sum certain. It is important that parties to a transaction anticipate which state's law applies to an assignment of rights under insurance policies they intend to follow the buyer after closing.

Conclusion: Insurance can be a valuable hedge against risk in a sale or merger

Thinking about coverage for post-transaction claims, and whether the seller's insurance policies will transfer to the buyer post-closing, should be a key component of every due diligence checklist. Not thinking strategically about insurance when negotiating a merger or sale can be a missed opportunity to monetize risk associated with a deal and shift it to an insurance carrier's balance sheet.