Insurance Due Diligence in Mergers & Acquisitions:

Going for the Money and The Information-Avoiding Gaps & The Abyss

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Generally, when companies are merging, acquiring or being acquired, the last issue of concern in the transaction is insurance. Ignoring insurance can be very expensive and the issues arising from a failure to pay attention to insurance may persist for years. Below are a few rules and a check list to assist a business in maximizing coverage, avoiding gaps, learning necessary information it may not be able to discern otherwise about the other entity in the transaction, assisting a business in obtaining monies that it may be unaware that it is entitled to, and in assuring that the business is protected.

Rule No.1 Get The Policies-All Of Them: Always get as many policies of insurance the entity to be acquired has as soon as the transaction begins and as far back as there are records, including: liability, errors & omissions, property, directors & officers, employment practices, workers compensation and fiduciary liability policies. If at all possible, get at least 5 prior years of each type of coverage. A particular concern arises where the entity to be acquired may have exposure for environmental liabilities that may be covered by older CGL (Commercial General Liability) policies issued before the absolute pollution exclusion became standard around 1984. Whether it is groundwater contamination or asbestos exposure, you may be able to get payment for current or future claims if you can establish coverage under a policy issued by a financially solvent insurer. Even older policies with lower limits can provide substantial funds to defend claims long after these policies expired. As part of any due diligence, determine what CGL primary and excess policies are still in the company's possession and make sure they are not subject to any document retention program that will eventually lead to them being destroyed. If policies are unavailable, have the acquired entity contact its broker(s) to get copies. This needs to be done as soon as negotiations become serious. Caveat: If you wait until the deal is closed, you will not get the policies, as the acquired/merged entity and its personnel and former brokers, will have no interest in assisting you.

Rule No. 2 The Policies May Have Information You Want: Policies of insurance are a treasure trove of information. If at all possible, you want copies of the applications for each policy. Policy applications usually contain a loss history (list of prior claims) and a listing of potential anticipated losses. This data may be more complete than the information provided in merger and acquisition disclosure documents. Notably, for directors and officers liability policies, errors & omissions policies, employment practices policies and a number of other types of policies the application is part of the policy. If it is not attached to the copy of the policy you receive, ask for it and any available loss runs as well. Unless the policy is merely

a renewal and the insurer does not require renewal applications, it is attached to and made part of the previously mentioned types of coverage.

Rule No. 3 There May Be Money There: If you are acquiring a company and its employees, you will need to audit their workers compensation policies, outstanding claims reserves and the status of premiums. The claims experience under a workers compensation policy can affect premiums for several years. Sometimes claims which could be settled and closed are ignored and as a result they adversely affect loss history for several years and thereby increase premiums. Additionally, employees may be classified at a higher rating than they should for premium purposes, which an audit may reveal, and reclassification can greatly reduce premiums. Lastly, some policies are retrospectively rated and settlement, closing of, and proper accounting for claims can actually result in a return of premium. If claims and losses are greater than anticipated for a given year, however, insurers issuing these retrospectively rated policies may also seek additional premium. Consequently, a workers compensation claims audit is well advised.

Rule No. 4 Make Sure All Insurers Know Of The Merger/Acquisition: The acquiring/surviving company for a merger/acquisition which increases the Company's size by 10% or more, likely needs to advise its current insurers of the merger/acquisition (some policies have requirements for notice which do not apply until there is a 50% change in ownership, although 25% is more common), as failure to provide such notice may void and/or limit the acquiring/surviving company's coverages. Generally, policies have a 30-60 day grace period for notification of mergers/acquisitions. Insurers do not hesitate to enforce these notice provisions, as insurers take the position that an insurance policy is a contract and the new company is not the party they contracted with. Similarly, many policies which were issued to the merged and acquired companies are voided when they are merged/acquired. Do not rely upon a policy of insurance for an acquired/merged entity staying in effect without verification from the insurer(s). To avoid gaps in coverage, the purchase of nose and/or tail coverage should be considered.

Example: Company A acquires Company B, increasing A's size by approximately 30%. Broker for Company A is aware of the transaction, but fails to notify Company A's D&O and Employment Practices Liability Insurer of the acquisition. The broker does cancel Company B's D&O and Employment Practices Liability Insurance. Unfortunately, several incidents of sexual harassment occurred when the employee was with Company B, pre-acquisition, and continued after Company B was acquired by Company A. The employee files a claim more than 90 days after insurance for Company B has been canceled and beyond any extended claims reporting period for claims arising out of events within the policy period. Thus, there is no coverage for the claim under Company B's insurance. Unfortunately, the employee's claim against Company B is not covered under Company A's insurance, as Company A's insurer was never advised as to the acqusition of Company B, much less accepted coverage for Company B post acquisition.

Rule No. 5 Do Not Assign Coverage Without Insurer Approval: Almost all insurance polices have an anti-assignment clause. Not surprisingly, insurers take the position that an insured may not assign policy benefits without its concurrence. If a company is acquired and remains a separate entity, this is normally not an issue. However, if there is a merger, unless an insurer agrees to the assignment of policy benefits to the acquiring company, any assignment between the merging companies may not only be ineffective, it may also void the policies of the merged company.

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