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Watch the Gap

Delegating M&A insurance issues to a broker is risky business

By Thomas S. Novak / Sills Cummis & Gross P.C.

Your company has announced a transaction whereby it will either sell a substantial portion of its assets, merge with or have its stock acquired by another company. As in-house counsel for the seller, you become consumed in responding to due diligence requests by the purchaser, producing customer contracts, billing records, financial information, employment records, litigation reports, regulatory filings, etc. One area that may be overlooked or left to an insurance broker is the effect of the transaction on the selling company's insurance program. However, delegating insurance issues to a broker who may not be sophisticated in corporate mergers and acquisitions may leave a hole in your company's insurance coverage and render your company and its management uninsured. This article explores some of the issues arising out of M&A transactions.

Virtually all director and officer (D&O) and errors and omissions (E&O) liability policies are written on a claims-made basis. A claims-made policy covers only those claims made within the policy period based on acts or omissions that occurred after an earlier specified time period. Such policies typically have a change in control clause. This clause usually provides that upon the change in control of more than 50 percent of the voting stock of the named insured or upon the sale of substantially all or a specified percentage of the assets of the company, the coverage of the policy terminates and the policy goes into run-off for the rest of its term. This means that the policy will not cover claims that arise from acts or omissions that occur after the date of the transaction, and the remainder of the policy term is converted into a reporting period for claims based on facts that arose prior to the transaction. As a result, your company's directors and officers may not be covered for their acts and omissions after the transaction date. If the transaction is a sale of assets where the seller will remain in existence afterwards, a new policy covering its directors and officers for post-transaction events will be necessary.

If the transaction results in the seller going out of business, consideration should be given to purchasing a "tail." A tail is actually not a new policy, but rather is an endorsement amending the D&O policy in effect at the time of the transaction that extends the time in which claims may be reported by one or more years. It can only be purchased from the carrier who issued the policy in effect at the time of the transaction. The tail does not provide a new limit of liability. The tail is subject to the remaining limit of liability of the policy that it amends. Since the tail endorsement is usually limited to extending the time period for reporting claims, the terms of the tail will generally be identical to the policy it amends. Oftentimes the availability, cost and length of the tail may be specified in the current policy. Other policies simply provide that the issuance, cost and length of the tail are subject to the discretion of the carrier at the time of the change in control. N.B.: When purchasing a D&O policy in the first place, consideration should be given to buying one that requires the carrier to offer tail coverage and specifies the cost and length of the tail in advance. Otherwise you are at the mercy of the carrier regarding the availability, cost and length of the tail.

> ***An insurer does not know corporate law as well as you do.***

If a tail is not offered by the carrier or is offered under terms that make it prohibitively expensive, limited tail coverage may be obtained through the insured's issuance of a notice of circumstances that may lead to a claim. Claims-made policies generally don't cover claims first made after the policy expires. One exception to this rule is that most D&O and E&O policies contain a provision permitting the insured to give the carrier notice of circumstances that may lead to a claim. The notice of circumstances then acts as a placeholder on that policy such that any future claims that arise from the circumstances noticed

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will be covered by the policy regardless of whether the claims are brought after the expiration of the policy. Post-expiration coverage is limited to claims arising from the noticed circumstances. Many policies have specific requirements as to the information that must be provided. Accordingly, it is important that the notice of circumstances be as detailed as possible in order to comply with the policy requirements and to encompass as many future claims as possible. The notice should also be as broad as possible to encompass any conceivable claims. The limitation to this approach is that coverage will be limited to those claims that are somewhat foreseeable.

Change of control issues are not limited to claims-made policies. General liability policies are almost always written on an occurrence basis but may also contain a provision terminating coverage upon a change of control of the named insured. If the seller will remain in business after the transaction and needs general liability insurance for post-transaction acts or omissions, the only solution is to purchase a new general liability policy. Tail coverage for future general liability claims arising from injuries sustained prior to the transaction is not necessary (or even offered), because the coverage of occurrence policies is not limited to claims arising during a specified reporting period. An occurrence policy covers injuries that occur during the policy period regardless of whether the claim is brought one year, 10 years or even longer after the expiration of the policy period. For example, asbestos bodily injury claims may trigger policies going back to the 1940s or earlier. This is because the etiology of asbestos-related diseases is that the asbestos particles cause damage upon inhalation and continuously thereafter. That is why in most jurisdictions, asbestos bodily injury claims trigger all general liability policies in effect between initial inhalation and manifestation of asbestos-related disease.

One other area where there may be a gap in coverage as a result of an M&A transaction is product liability claims. Product liability coverage is one of the few coverages that is commonly written on either an occurrence or claims-made basis depending on the extent of the insured's risk and financial ability to pay the premium. Product liability insurance was historically offered on an occurrence basis and is still written that way for low-risk insureds. However, insureds with a high product liability exposure may be forced to obtain such insurance on a claims-made basis because occurrence coverage is unavailable or the premium would be prohibitively expensive.

Regardless of whether the seller continues to make or distribute products after the transaction, it may get sued in the future based on products made in the past. If the seller's products liability insurance was written on a claims-made basis and the change in control clause is triggered, it will be necessary to purchase a tail endorsement to the last policy in order for there to be coverage of post-transaction claims. The same issues concerning availability, cost and length of the tail apply here as with D&O coverage.

If the seller's coverage was written on an occurrence basis, it should continue to purchase products liability insurance after the transaction even if it no longer manufactures or distributes products. This is necessary in order to cover post-transaction injuries. If a product was manufactured or distributed by the seller prior to the transaction but the product causes an injury after the change in control, the claim will not be covered by the seller's products policy in effect at the time of manufacture or distribution. The seller must continue to purchase additional products liability coverage after the transaction to insure against future injuries from past products.

Additional protection may also be obtained by having the buyer named as an additional insured on the seller's products liability policy going forward. To effectuate additional insured status, it is essential that the agreement require the buyer to name the seller as an additional insured on its policy. Further, to the extent that existing contracts entered into by the seller will be assigned to the buyer and those contracts name the seller as an additional insured on the counterparty's liability policies, the buyer should make sure that such contracts are amended to provide that the buyer be named as an additional insured on such policies. This is because the ISO "blanket additional insured endorsement" in many policies limits its additional insured coverage to those entities with which the named insured has a written agreement requiring it to name the entity as an additional insured on its policies. Much coverage litigation has arisen where a party thought it was an additional insured on another's policy, only to find out that the absence of the requisite additional insured clause is fatal to additional insured coverage.

The need for insurance against legacy product liability claims may not be limited to the seller. Some states like California and New Jersey have adopted the "product line" theory of liability that holds a purchaser of assets liable for the product liabilities of companies whose assets it purchased. The buyer's regular product liability policy is usually not going to cover it for claims arising from products it did not manufacture or distribute. One solution is for the buyer to require that the seller name it as an additional insured on the seller's post-transaction product liability policies. Practically speaking, however, this provision is hard to enforce in future years and does not protect the buyer if the seller goes out of business. A better solution is for the buyer to purchase "discontinued products coverage." This coverage insures the buyer against product liabilities from injuries arising from products manufactured or distributed by the seller prior to the transaction.

The bottom line is that an insurance producer does not know corporate law or your business as well as you do. Careful consideration of your existing insurance program, risk profile and future business strategy is essential to avoid unexpected gaps in coverage.

The views and opinions expressed in this article are those of the author and do not necessarily reflect those of Sills Cummis & Gross P.C.