Managing Insurance Coverage During Mergers & Acquisitions

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About Mergers and Acquisitions

In today's business environment, corporate America has experienced much consolidation. Merger and acquisition activity is at an all-time high. With each instance, there's always some level of company due diligence which takes place prior to and during a corporate merger or acquisition. However, there are important facets other than EBITDA or Cash Flow, like insurance coverage, which tend to be overlooked. This paper addresses specifically Professional and Management Liability issues to consider in a merger or acquisition. For any business or professional services firm with a professional or management liability insurance policy in place, not being aware of the coverage implications during a merger or acquisition can impact both companies as they move forward and could lead to disastrous results.

Mergers and acquisitions occur for many reasons – here are some of the most common ones:

- To grow or enhance current products or services
- To complement a business strategy
- To control market share (buying out competitors)
- To buy companies with more efficient operations
- Consolidation of operations
- To avoid Chapter 11 bankruptcy or erase company debt
- To assure perpetuation of a partner's financial interests

MERGERS

In a merger, two separate companies are brought together to form a single new entity. Mergers are relatively common. They involve shareholders swapping stock of one company for another. Even in the best of mergers, one company survives and that can create disgruntled shareholders on either side. Often one or both companies' stocks are surrendered and new company stock is issued in its place. The new company is typically referred to as NEWCO and the acquired company or the one dissolved is referred to as OLDCO. NEWCO may own the shares of either companies or the two previous companies may surrender their shares. OLDCO is often dissolved but the liabilities of the shareholders/partners still remain.

ACQUISITIONS

Just like mergers, acquisitions happen when companies are seeking to change or enhance their economies of scale, market visibility or simply when shareholders want to sell out. An acquisition occurs when one company takes over another and clearly establishes itself as the new owner. The transaction can be with cash, stock, a combination of cash and stock, or they simply acquire the assets of another company. From a legal point of view, the target company may cease to exist or continue as an operating subsidiary of the other company.

M&A activity is rampant today in almost every sector. As companies are performing their due diligence, evaluating their EBITDA and cash flows, they often omit the insurance discussion until it is too late. For any business or professional services firm with a professional or management liability insurance policy in place, not being aware of the coverage implications during a merger or acquisition can impact both companies as they move forward. Lack of proper insurance can lead to uncovered claims and uncovered indemnifications that were not contemplated in the original merger transaction. In this document we have highlighted several issues that need to be considered when evaluating insurance issues in an M&A transaction.

M&A TRANSITION INSURANCE CHECKLIST

When a merger or acquisition is in progress, both companies involved in the transaction should consider reviewing or updating the following:

Schedule of Insurance - You should prepare a schedule of insurance outlining all insurances, effective dates, expiration dates, limits, deductibles, premium and who is/is not insured under the policies. This will help both parties understand what is currently covered and not covered.

Adequacy of Limits and Coverages - When merging two entities, often there are philosophical differences on insurance. It is important to determine if the limits, deductibles and annual costs of separate limits are still appropriate for a larger combined entity. Further, the systems and controls of a new entity might be different than the separate entities and therefore in need of evaluation. You should be prepared to see higher deductibles for larger consolidated companies.

Contracts and Agreements – A schedule of all third party contracts should be prepared. This should include, at a minimum, contracts with vendors, third parties, cloud providers, independent contractors, employees or others.

The contracts or agreements which exist in both companies must be investigated and updated to reflect the compliance standards of the new entity. Each party may be subject to third party agreements which may have terms and conditions that can cause issues, such as non-transferability, extended reporting and contractual liability, additional insured status and even ownership of client lists. These contracts can be between vendors, third parties, independent contractors, employees or others. Most contracts are not transferrable. Additionally, both companies may have contracts with the same third party vendors and therefore will need to be evaluated.

Employment Practices and Contracts – In most cases, both the old and new company will have different policies and procedures as it relates to employment related matters. Certain employees may have contracts that allow them to terminate non-compete or non-circumvention agreements. In other cases, since OLDCO may cease to exist, any existing contracts may not be enforceable by the Newco. Additionally, the company may need to right size the personnel and terminate, reassign or otherwise change current working conditions. The acquiring company needs to have a good understanding of the employment environment and consistently apply new policies and procedures to all employees in the transition. Any potential issues which the company believes should be reported to the EPL carrier for each company should be done prior to the date of the closing. The new carrier will most likely not cover any previously known events.

Claims Made Issues – Most professional and management liability policies are written on a claims made basis. This means that it only covers claims "made" against the insured during the policy period or the extended reporting periods that may be automatic or reported. One issue is that although these policies allow for reporting "incidents" during the policy period, there typically isn't any provision for reporting incidents after the policy period or during the extended reporting period (tail policy period or ERP). Many issues that are known to the seller prior to the date of sale but didn't believe rose to the level of a "claim" under the policy come to light shortly after acquisition. This can create problems as noted in the Employment Practices section above in that known matters can be excluded under the new policy and be subject to late notification on the OLDCO policy. A detailed review of any potential litigation, errors or omissions or threats of litigation should be reported prior to the expiration of any policy or the merger date.

Insurance Policies – Neglecting to consider policy term dates and other important account updates could result in uninsured losses. A newly formed entity may be in a better financial position after a merger or acquisition, however, in order for it to remain protected from liability there will need to be changes made to the new company's insurance coverage. Every insurance carrier must be notified. This should be done in advance of the acquisition, as some policies may terminate. We have highlighted below some common issues with professional and management liability insurance policies in a merger and acquisition transaction.

CHANGE IN CONTROL PROVISIONS IN ALL POLICIES

Most insurance policies have a provision that describes what happens in the event of a change in control or management of the company. In general, coverage will usually cease as of the date of the change in control (i.e. sale of a majority of the stock, merger representing more than X% of the stock or even a termination of operations or a change in board control). It is extremely important that each policy is reviewed to determine what coverage is in place. We have seen many cases where claims made policies terminated and the acquired company had to purchase a “tail policy” that was not contemplated in the cost of the acquisition.

Examples of Change in Control Provisions – Whenever there’s a shift in corporate ownership, it will impact a company’s insurance coverages. On average, if there is a change of between 25-50% of the voting stock, change in control provisions will apply in most insurance policies. Drastic changes in the share of control could lead to a termination of the company’s insurance policy. Here are some examples of change in control provisions in professional or management liability policies:

- The policy terminates effective immediately and will not cover any claims for services provided subsequent to the acquisition date.
- The policy continues to stay in force until the expiration date of the policy; it will not cover any claims for professional services subsequent to the date of the change in control.
- The policy becomes paid in full. This means that there will be no returned premium in the event of cancellation of the policy. This is important since most carriers will allow the insured to use unearned premium to offset the cost of an extended reporting endorsement. In this case, there would not be any returned premium.
- Insurance policies may only allow purchase of an extended reporting endorsement if the carrier cancels or non-renews the policy or if the policy has been in force more than a certain period of time. An insured may not have the ability to purchase an extended reporting endorsement in the event of a sale, merger, or simply closing their business. This clearly needs to be considered before structuring the ultimate sale or merger agreement and any indemnity agreements.
- The insured only has a specific amount of time to report the change in control to the carrier and pay premiums relating to any extended reporting endorsement. Failure to report the sale/merger to your carrier within the time period (typically 30 days), results in the insured not being able to purchase an extended reporting endorsement. This means there will be not be any coverage available to pay claims reported in the future that may have occurred during the policy period.

Under claims-made insurance programs, the policy that is in force on the day of the lawsuit or the claim is “made” against the company responds, rather than the insurance policy that was in force the day of the incident or occurrence. Issues may arise, however, if a policy is cancelled upon an acquisition or divestiture and a lawsuit is brought in the future (e.g., one year later). Similarly, asset only transactions where liabilities are not passed to an acquiring company may raise concerns as well.

KEEP YOUR BROKER INFORMED

Some carriers may accommodate a change in control, even if the policy says otherwise. It is best to notify the carrier/broker at the earliest point possible, so you know of any issues or additional costs. With Professional and Management Liability insurance” there are certain provisions which companies and investors should be aware of.

EXTENDED REPORTING

Standard Professional and Management Liability insurance policies typically provide an extended reporting endorsement for purchase. This additional coverage purchased allows an insured to report claims in the future for wrongful acts that occurred subsequent to the retroactive date in the policy and prior to the date of the acquisition for some period. This additional period of time to report claims is purchased in 12 month increments typically ranging from 12 to 60 months; the most common being 36 months. The cost of the additional time to report claims averages about 100% of expiring premium for 12 month to 200% or 250% for 36 months.

From the acquiring company's standpoint, the ERP serves as collateral for future losses that may come about as a result of the acquired company's activities prior to the date of acquisition. An indemnification is only as good as the individual or company backing the indemnification. In an acquisition situation, because the OLDCO will most likely close down, there will be no assets to indemnify or protect partners or shareholders of either company. That is why we recommend at least 5 years for an ERP.

INSURED ENTITIES AND PREDECESSOR COMPANIES

The acquiring company will typically add E&O coverage for the acquired entity on its own policy. It is imperative that the acquiring company work closely with the broker and the acquired company to ensure that the policy provisions, named insureds and covered professional services are properly listed on the new policy. Often companies that were acquired or sold in the past are not listed on the new policy and are subject to future uncovered claims. A specific list of all companies, DBA's, and predecessor companies should be provided to the new company and its broker. Most frequently, the current insurance carrier will add the new company (retro inception), so it will only cover claims that occur on or after the date of acquisition.

PROFESSIONAL SERVICES

Each company is unique and so are their professional liability insurance policies. When moving E&O coverage to the new entity, it is imperative that the full scope of professional services of the acquired company be taken into consideration. We often find that the acquired company's E&O policy is less comprehensive and the uniqueness of the professional services provided by the acquired company is simply overlooked. It is important to make sure that these professional services are covered under the acquiring company's E&O policy. Often such nuances are overlooked in the acquisition. Most professional services companies have put contracts in place which require their coverage be maintained for a specific time after the contract period.

ENTITIES/DIVISIONS ACQUIRED

In some acquisitions, only a portion of a company is being acquired. This creates issues since it addresses the issue of: "can you purchase an extended reporting endorsement for only a portion of the policy". Another issue to consider is that when a substantial portion of a company is sold, its liabilities may still remain. What this means is that the operations remaining will continue to have to pay E&O premiums based on the combined entity for about 3 to 5 years depending upon the nature of the business. The company remaining may not have taken this into consideration. They may have to continue to pay for the risk of the entire entity, subsequent to the sale.

LOSS EXPERIENCE

Review the loss experience of each policy in relation to the overall limits. It is possible that even though you might purchase a tail policy, there may be significant claims activity already. An Extended Reporting Endorsement (Tail Policy) only extends the time to file a claim that occurred during the period covered by the policy. A current claim could already exhaust current limits. You should evaluate if the current policies are adequate to cover potential future risk.

INDEMNIFICATION PROVISIONS

Review the indemnification provisions of the purchase agreement. It is important to understand that the selling company will need to indemnify the acquiring company for future losses that might be related to the time they owned the company. Insurance helps mitigate that risk, however, the indemnification risks remain regardless of whether or not the insurance is adequate. Therefore you need to consider the amount of time to purchase an ERP or Tail policy. Most sellers only want to buy what they are required to buy (typically three years). However, with or without the insurance they are still liable for indemnification. In most cases, the seller takes the money personally and will be unable to indemnify the acquiring company, absent the ERP. We recommend most companies purchase a 5 year tail.

REPS AND WARRANTY INSURANCE

In the acquisition process, the management of the acquired company has to make many representations including current clients, estimated revenues, and contracts that are in place including partner and employee contracts. Additionally, they may have to assess certain liabilities such as environmental exposures, regulatory issues, pending litigation and on-going concern issues. A buyer may require a Reps & Warranty policy to help insure against the validity of such representations by the potentially acquired company.

In evaluating reps and warranties insurance, here are some things you should consider. First, it's not cheap. Most carriers will require an upfront fee of a minimum of $15,000-$25,000 just to underwriter the deal. Larger deals will cost more. Second, they require a risk corridor and don't insure unlimited exposure. So for example, they might insure a potential environmental exposure for $5M excess of management's estimate of a potential $5M exposure and even in doing so they will require a deductible of usually at least $250,000 or more. Third, the premium itself is usually a minimum premium of at least $150,000, however, most deals are more than that. Companies typically would not buy this type of insurance except in a larger deal. ($500,000 deductible, $150,000 premium).

One other thing to consider is that most reps and warranty insurance is sold to the buyer. The reason is simple. They are insuring against misrepresentations. There is an inherent conflict of buying a policy to protect against your own misrepresentations.

BUYER/SUCCESSOR CORP ENDORSEMENT

A suit against a seller may invariably bring liability to a buyer even though they were not involved in the claim on the date of the wrongful act. If possible, you should attempt to get a Buyer/Successor Corp endorsement for purposes of authority and notice. This could help defend the buyer company for your actions.

SUMMARY

Although the above has not addressed every possible issue associated with a merger or acquisition, we believe it highlights some of the more important insurance issues to consider. Please feel free to contact Mike W. Smith at 201-847-9175 ext. 105 or msmith@axisins.com.

About Axis Insurance Services, LLC - Axis Insurance Services, LLC is a licensed professional liability insurance brokerage located in Franklin Lakes, NJ with licensed insurance agents nationwide. We offer customized professional liability solutions in the areas of Errors and Omissions insurance (E&O), Directors and Officers liability (D&O), Employment Practices Liability (EPLI), Privacy/Network Security, Commercial Crime and Fiduciary coverage for today's professional services companies. We serve all types of businesses, including real estate professionals, insurance professionals, third party administrators, medical groups, architects, engineers, accountants and many others.

For more information on Axis Insurance Services, LLC: www.axisins.com or call 201-847-9175

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Schedule of Insurance
Mergers & Acquisitions

Policy Type	Insurance Company	Effective & Expiration Dates	Limits	Deductible	Contact (Agent)	Contact Phone/Email	Annual Premium	Losses Paid/OPEN Contact Information

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AXIS INSURANCE SERVICES, LLC

Transition Insurance Checklist
Mergers & Acquisitions

	Received & Reviewed	Notes & Follow-Up
Schedule Of Insurance		
Adequacy of Limits		
Contracts & Agreements		
Employment Contracts		
Claims-Made Issues		
Change in Control		
Extended Reporting Period		
Entities Insured & Predecessor Firms		
Professional Services		
Entities/Divisions Acquired		
Loss Experience		
Indemnification Provisions		
Representations & Warranties Insurance		
Buyer/Successor Endorsement		

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