RT ProExec INSIGHTS

VOLUME XXVI ISSUE 1 FALL 2023

COVERAGE CONSIDERATIONS FOR MERGERS AND ACQUISITIONS

In 2022 there were over 20,000 mergers and acquisitions in North America, according to S&P Global Market Intelligence data. Parties involved in such a transaction face many demands as they endeavor to strike a deal, often against a backdrop of looming deadlines and shifting targets. Matters of insurance can take a back seat in these circumstances, but careful consideration of risk management – including appropriate insurance coverages – should be a part of the dealmaking process. The following is a discussion of certain key issues that may be considered by parties engaging in M&A activity.

Regardless of the type of transaction (e.g., merger, acquisition, consolidation, reorganization, etc.), the "change of control" and "run-off" provisions of a standard Management or Professional Liability insurance policy will likely be implicated. In this context, it is also important to understand the concept of go-forward coverage, and how coverage should apply to "prior wrongful acts."

Change of Control

Broadly speaking, a "change of control" (CoC) refers to a change in the majority ownership of a company. However, whether a CoC provision in a Management or Professional Liability insurance policy is triggered depends on the nature of the transaction, along with the applicable policy language. Examples of when the CoC provision is typically triggered include when there is a sale of all (or substantially all) of the company's assets to another party, or the company undergoes a stock sale that results in more than a fifty percent (50%) change in ownership. The specific policy language at hand may allow other transactions to trigger the CoC provision, including a merger and consolidation into another organization – often involving policy language to the effect of, "such that the Company is not the surviving entity."

Run-Off Coverage

Run-off coverage applies to claims made post-transaction for alleged wrongful acts that occurred prior to such transaction. When a CoC provision is triggered, a Management or Professional Liability insurance policy will typically continue, but only for wrongful acts of the insured / selling organization that occurred prior to the transaction. At this stage, the policy is known to be in "automatic run-off" until expiration of the policy period, and the policy premium usually becomes fully earned. With rare exception, the insured / selling organization has the option to purchase an additional run-off period from their insurance carrier that extends coverage beyond the natural expiration date of the policy. Such terms may be pre-determined and set forth in the policy document or may need to be negotiated with the insurer at the time of the transaction. Either way, insureds are usually afforded terms for one (1), three (3), and six (6) year run-off periods, with many D&O insureds opting to purchase 6 years of coverage (accounting for most potentially applicable statutes of limitations in the United States).

It is helpful to keep in mind the interplay between run-off coverage and the claims-made nature of Management and Professional Liability insurance policies; coverage must be active at the time a claim is made. An additional run-off period provides the mechanism for a claims-made policy to respond with respect to a prior wrongful act.

The motivation or drive to purchase run-off coverage can come from either the insured / selling organization, or the party acquiring / taking control (or both). When engaging in M&A activity, a company's directors and officers may not be aware of an issue that could lead to a claim down the road. Run-off coverage allows those executives to protect themselves from future claims not yet known about, pre-transaction. An acquiring organization with a different executive team and potentially different goals or strategies for the company can lead to significant changes to the company's operations, finances, and legal exposures. However, even when operations are to remain relatively consistent through a transaction, some purchase and sale agreements (or other transaction related contracts) require the selling company to secure run-off coverage to cover past liabilities. A new, "go-forward" policy can then be secured that is not exposed to claims that may arise from wrongful acts of previous executives or out of pre-transaction operations.

Go-Forward Coverage

Go-forward coverage is an insurance solution for an acquiring / emerging company (NewCo) and its directors and officers for claims alleging wrongful acts occurring after the CoC, subject to the terms and conditions of the policy. This is a separate policy from the run-off coverage discussed above. A go-forward policy usually contains a prior acts exclusion as of the date of the CoC, so that its coverage applies solely to wrongful acts of the NewCo and its directors and officers – not the prior executive team or operations of the company under the management of those (pre-transaction) directors and officers.

Structuring run-off and go-forward coverage can become complex when there is only a partial turnover of the executive management team. In this scenario, an insured may request that the insurance carrier waive the CoC to the effect that run-off is not triggered and coverage can remain in force without limitation as to whether a wrongful act occurred pre- or post-transaction. While this can be enticing from a premium savings perspective and may be a fitting solution for some insureds, whenever there is a less than complete turnover in executive management, it is imperative for insureds to understand the potential for a policy's limits being diluted by both wrongful acts of the prior management team, and wrongful acts of the NewCo and post-transaction management team.

Straddle Language

When a claim alleges a series of wrongful acts, some of which occurred prior to a CoC and some of which occurred post-transaction, there can be confusion regarding how an insured entity and its directors and officers should be covered, including which Management or Professional Liability insurance policy is triggered. These types of claims are referred to as "straddle claims." While perhaps not widely available in the Private Company marketplace as of this writing, straddle language can help an insured avoid uncertainty with respect to coverage for a straddle claim – and should be considered when possible.

Addressing the Exposure

Management & Professional Liability

Run-Off Coverage:

- Available in terms ranging from one (1) to six (6) years
- Can be secured for "bare" insureds (with no prior coverage)
- Can contemplate ancillary lines (e.g., EPL and Fiduciary in addition to D&O)
- Achieved via endorsement to the policy, with reference to the CoC date
- Straddle language can be considered depending on how the run-off and go-forward policies are structured

Go-Forward Coverage:

- Typically includes a Prior Acts exclusion as of the CoC date
- In a strategic or "roll up" deal, it is important to review the go-forward coverage to determine how the insurance carrier treats add-on acquisitions or mergers. Often, an acquisition threshold for new acquisitions is included in a carrier's base policy form. However, it should be noted that even if a policy provides automatic coverage for acquired subsidiaries, such coverage is only for wrongful acts occurring after such time as the entity became a subsidiary.

Privacy Liability

Run-Off Coverage:

- Can often be purchased for a period of one (1) to three (3) years
- Can be secured for "bare" insureds (with no prior coverage)

Go-Forward Coverage:

- Depending on the go-forward program, run-off coverage may not be beneficial (e.g., when the go-forward policy provides "full prior acts" coverage).
- Subject to the deal and the insurance carrier, a go-forward program will typically either provide full prior acts coverage or contain a prior acts exclusion. As such, in a strategic or "roll up" deal, go-forward coverage will need to be reviewed to determine how the go-forward coverage will respond to the acquisition.

Transactional Liability

Transactional Liability insurance has gained a lot of momentum over the past decade and has become a valuable tool to help facilitate a successful transaction. It encompasses a broad spectrum of insurance solutions, including Tax Liability, Contingent Liability, and Representations and Warranties insurance.

Tax Liability Insurance provides protection for losses that may arise if an uncertain but identifiable tax position is challenged by a tax authority. Contingent Liability Insurance covers losses to a third party for which the insured is vicariously liable, including for issues related to litigation, intellectual property, employment, and environmental concerns (to name a few). Representations and Warranties Insurance aims to indemnify the insured for losses resulting from breaches of the seller's representations and warranties. The insured may be the buyer or seller. However, it is most common to structure Representations and Warranties insurance for the buyer (referred to as a "Buy Side" policy).

Although Transactional Liability insurance has become a mainstream component of U.S. M&A transactions, it is still a fairly new and evolving category of insurance products. In addition to focusing on the quality of a policy's terms and conditions, having a comprehensive understanding of the Transactional Liability insurance marketplace and its participants is essential. Further, brokers placing Transactional Liability insurance need to have a firm command of the process, timelines, and information flow, so that the placement is not a hinderance to the transaction.

In closing...

There are many insurance coverage considerations implicated by M&A activity. Having a broker that understands the various dynamics of these transactions and how to structure insurance solutions for the parties involved is crucial. We welcome the opportunity to discuss any of the above topics with you in further detail.

Please see next page for Frequently Asked Questions

Can the CoC provision be waived to avoid having to purchase both run-off and a go-forward policy?

- Under certain circumstances the insurer may consider waiving the CoC provision. However, regardless of the insurer's position, run-off coverage is often required under the terms of a purchase and sale agreement. Further, strategy may dictate that there be a clear delineation of coverage for pre- and post-transaction exposures.

What happens if the insured sells or acquires a subsidiary?

- Selling a Subsidiary – Generally, a Management Liability insurance policy will provide runoff coverage for divested subsidiaries, but only for wrongful acts that occurred prior to the sale. This coverage is usually only in place for as long as the former parent company maintains insurance
- Acquiring a Subsidiary – Management Liability insurance policies vary with respect to coverage for acquired subsidiaries. Some policies provide automatic coverage for subsidiaries regardless of their size or risk characteristics. Others include an asset acquisition threshold, commonly in the range of 15%-30% of the total assets or revenue of the insured / parent organization. In other words, if the total assets of the target company exceed 15%-30% of the insured / parent organization, the insurer has the right to underwrite the deal, assess an additional premium, and/or otherwise amend the policy terms and conditions. However an acquired subsidiary is addressed, coverage typically applies only to wrongful acts occurring after such time that the subsidiary was acquired.

If an Insured purchases D&O run-off coverage, do they need a Representations and Warranties policy?

- As noted above, Representations and Warranties insurance aims to indemnify the insured for losses resulting from breaches of the seller's representations and warranties. Understanding where D&O coverage starts and ends is imperative to successfully structuring an insurance program. For example, there are certain exclusions commonly found in a D&O policy, such as for breach of contract, that could create instances where representations and warranties made in the purchase and sale agreement are not covered by such D&O policy.

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