

# Three Practical Tips for Insurance Due Diligence in M&A Transactions

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PRACTICES Insurance Recovery, Litigation

Virtually every merger or acquisition includes representations or requirements regarding insurance. Every corporate counsel knows that warranties regarding the adequacy of insurance coverage must be verified. Every sophisticated director and officer will require ongoing insurance coverage and indemnification after the closing of a merger. Many experienced counsel are savvy enough to watch out for basic insurance traps like anti-assignment provisions.<sup>1</sup> But beyond the basics, really good insurance due diligence in transactions—the kind that will avoid forfeiture of coverage and fulfill the parties’ reasonable expectations—requires understanding of how a transaction may affect current insurance coverage and compliance with contractual insurance requirements. To ensure that valuable insurance coverage is preserved, maximized and performs its intended purpose, here are three “best practices” for insurance due diligence in M&A transactions.

## No. 1 - Compliance with Additional Insured Requirements

The insurance coverage protecting the predecessor/target in a merger or acquisition agreement may only be partially addressed in policies titled in the predecessor’s name. The predecessor company may be required to be covered as an additional insured under any number of policies procured and maintained by third-party vendors, suppliers and service providers. The additional insured endorsements naming the predecessor as “additional insured” under a third-party policy may be broadly worded to include any person or organization that the third party “named insured” is required by contract to add as an “additional insured.” This “additional insured” coverage may be limited to liability the additional insured has arising out of the third party’s ongoing or completed operations for the predecessor company.

Depending on the terms of the transaction, without taking affirmative action to protect this additional insured coverage, a merger may result in no “additional insured” coverage for the surviving entity. After all, for purposes of the blanket additional insured endorsement, there is no contract requiring the third party named insured to include the surviving entity as an “additional insured.” Nor, in the absence of that contractual relationship, could any liability the surviving company may have qualify as liability arising out of the third party’s ongoing to completed operations for the surviving entity. See, e.g., *JP Morgan Chase Bank, NA v. Zurich Am. Ins. Co.*, 2015 NY Slip Op. 31887 (N.Y. Sup. Ct. Oct. 13, 2015); *Ownbey v. Aker Kvaerner Pharmaceuticals, Inc.*, No. 07-2190 (D. N.J. Nov. 17, 2015). In the context of an acquisition, the acquiring company may need additional insured status with respect to the operations of the newly acquired target. Affirmative steps must be taken to secure “additional insured” status for the surviving or acquiring company under substantive contracts with third parties where exposure to potential liability is high. Similarly, to the extent that the predecessor company is obligated to name others as “additional insureds” or “loss payees” under its own policies, the surviving company should take appropriate action to make sure that compliance is maintained and counterparties on substantive contracts are not left uninsured for material risks.

## No. 2 - Exhaustion of Retentions and Deductibles

Most of the policies addressed in the representations and warranties about insurance in a merger or acquisition agreement will include some self-insured retention (“**SIR**”) or deductible that must be exhausted before policy benefits can be accessed. All other things being equal, under the terms of the applicable policy, it may be the named insured or an additional insured’s obligation to satisfy the applicable SIR or deductible. Once the transaction closes and the named insured has succeeded to a different entity or new parent, the question becomes, who is obligated and who is permitted to exhaust the SIR or deductible needed to release policy proceeds? Will payments made by the surviving or acquiring entity, otherwise a stranger to the policy, apply against an outstanding SIR or deductible?

The answer generally turns on the terms of the policy. Some policies may expressly require payment by the named insured, as opposed to the surviving entity or any other party. Other policies may expressly permit payment by others or may be merely ambiguous. In the latter case, the surviving/acquiring entity may take comfort that, assuming anti-assignment provisions and other obstacles are surmounted, the satisfaction of a deductible or SIR will not stand in the way of obtaining payments for defense costs, damages or other proceeds under a policy.<sup>2</sup> In the former case, the parties to a merger or acquisition agreement should be attuned to and aware of those policies that may contain this additional hurdle potentially limiting the coverage available to the surviving/parent entity.

## No. 3 - “Tail” Coverage

Parties will routinely require a six-year “tail” policy for D&O insurance (or other claims-made coverage) at closing for a merger or other transaction involving transfer of control of an entity. This is necessary because most D&O policies include “change in control” provisions, whereby a merger or other transaction transferring all or substantially all assets or “management control” of the insured organization will effectively terminate coverage for conduct occurring after the transaction is closed. Coverage under a tail will enable past and present insured directors and officers to have the benefit of coverage for claims made over the next six years for alleged “wrongful acts” committed prior to closing. The tail will collateralize ongoing indemnification and advancement obligations the surviving company owes to past and present directors and officers.

Apart from mandating the purchase of a tail policy, the parties to a merger or acquisition agreement (and their constituent directors and officers) should pay attention to other critical details necessary to provide for continuity and optimization of liability insurance coverage. Directors and officers will want a “single premium” tail policy so that the consistency of coverage will not be dependent on future payments from the surviving entity. Sophisticated insureds will also insist on placement of the tail policy with the same insurer providing the expiring entity’s D&O coverage. While the existing carrier may be able to quote the best price for a tail, the real efficiency in this strategy comes in avoiding disputes between different carriers in the event of a claim—each one asserting that the other has liability for a claim arising out of the M&A transaction. There may be other benefits to the insured entity and individuals from maintaining coverage with one carrier.<sup>3</sup> If the tail coverage is accomplished by endorsement to an existing policy, the insured organization must ensure that the surviving entity is identified as an “insured.” It will be the surviving entity that ostensibly will seek coverage for a post-transaction claim, and while a tail policy should never be construed to render its coverage illusory, including the names of both the predecessor and surviving entities may avoid disputes over which entity is entitled to coverage. Not as a substitute, but as a compliment to a tail,

prior to closing, insured individuals and organizations should give notice under the pre-existing policy of any and all existing claims and all circumstances known to the insureds and likely to give rise to a claim. While a tail will provide coverage for future claims for pre-closing wrongful acts, providing a “notice of circumstances” prior to closing may enable the insureds to seek coverage for all future claims involving the same or “related” “wrongful acts,” potentially whether those acts occurred before or after closing.

A multitude of other insurance-related issues will inevitably arise and require consideration in a substantive merger or acquisition transaction. How will existing first-party claims, unresolved at the time of the closing, be handled? In this era of the daily, high-profile data breach, is network security/privacy liability insurance a material policy the absence of which may have a “material adverse effect” for purposes of representations and warranties about insurance coverage in a merger agreement? As between insurance maintained by the predecessor entity and those policies to be procured by the surviving entity, which policy will have priority in a claim covered by more than one policy? Will any insurer have subrogation rights against any party to the merger or acquisition? While each of these questions deserves separate treatment, the ultimate answer to each and the most practical advice parties to a merger or acquisition agreement can receive is to seek out competent and experienced counsel to give thoughtful consideration to insurance during the diligence process.

If you have questions about insurance due diligence in M&A transactions, please contact one of the Haynes Boone [Insurance Recovery Practice Group](#) partners listed below.

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<sup>1</sup> Many first-party and third-party insurance policies contain anti-assignment provisions, which prohibit the transfer of an interest under a policy without the insurer’s consent. Some jurisdictions strictly enforce anti-assignment clauses as written, while other venues permit assignment of policy benefits without the insurer’s consent, either by common law or statute, if the assignment takes place after the loss or injury has been incurred. Compare, e.g., *Tex. Farmers Ins. Co. v. Gerdes*, 880 S.W.2d 215, 218 (Tex. App.—Fort Worth 1994, writ denied) (holding that an anti-assignment clause precluded a third-party beneficiary from assigning her rights without the insurer’s consent) with *Viking Pump, Inc. v. Century Indem. Co.*, 2 A.3d 76, 103 (Del. Ch. 2009) (“New York law generally does not permit anti-assignment clauses to be erected as a barrier to the transfer of ‘post-loss claims,’ that is to say claims for losses that have already happened.”).

<sup>2</sup> See, e.g., *Cont. Cas. Co v. N.A. Capacity Ins. Co.*, 683 F.3d 79, 90 (5th Cir. 2012) (“Although it is undisputed that [the insured] never paid its self-insured retention limit, the policy does not explicitly require the insured to pay the amount itself. Both Continental See, e.g., *Cont. Cas. Co v. N.A. Capacity Ins. Co.*, 683 F.3d 79, 90 (5th Cir. 2012) (“Although it is undisputed that [the insured] never paid its self-insured retention limit, the policy does not explicitly require the insured to pay the amount itself. Both Continental and National Union spent millions of dollars on [the insured’s] defense, thereby satisfying the self-insured retention limit. Such a limit represents the amount of the loss that the insured is responsible for before coverage is triggered. Conversely it is the part the insurer is not responsible for. Here, this responsibility was met on the insured’s behalf.”); *Hartford v. Fed. Ins. Co.*, 843 F. Supp. 2d 1011, 1016 (N.D. Cal. 2012) (construing a policy stating that “[w]e have no obligation or liability under such Coverages unless and until the applicable Self-Insured Retentions as described in the Schedule are exhausted by payments you make . . . . You must pay all self-insured retention expenses” and finding that “the policy does not clearly require the hotel to satisfy the SIR out of its own pocket.”); *Fla. Ins. Guar. Ass’n v. Jacques*, 643 So.2d 101, 102 (Fla. Ct. App. 1994) (finding that the insured’s deductible for its general liability policy could be satisfied by payments made under the insured’s business automobile insurance policy).

<sup>3</sup> See, e.g., *Zenith Ins. Co. v. Commercial Forming Corp.*, 850 So.2d 568, 570 (Fla. Ct. App. 2003) (“[U]nless notice is given to the contrary, upon renewal of coverage by the payment of the new premium, the parties are entitled to assume that the terms of the renewed policy are the same as those in the original contract.”); *Woodlawn Fraternal Lodge No. 525 v. Commercial Union Ins. Co.*, 510 So.2d 162, 164 (Ala. 1987) (“[T]he burden is on the insurer to notify the insured if the renewal policy differs from the original policy. Failure to notify the insured will result in the insured’s being entitled to coverage under the policy as originally issued.”); *Canadian Univ. Ins. Co., Ltd. v. Fire Watch, Inc.*, 258 N.W.2d 570, 575 (Minn. 1977) (“[W]hen an insurer by renewal of a policy or by an endorsement to an existing policy substantially reduces the prior insurance coverage provided the insured, the insurer has an affirmative duty to notify the insured in writing of the change in coverage. Failure to do so shall render the purported reduction in coverage void.”).