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Successor Liability and Insurance:

Think Insurance When Considering Mergers, Acquisitions and Spinoffs

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Today's litigious society forces all companies considering a merger, acquisition, or spinoff, to understand all aspects of the target company's (or their own) liabilities and assets. Often overlooked, however, in the examination of liabilities and assets is a review of insurance.

The liability picture is not complete without a thorough understanding of the historic insurance assets available to cover those liabilities. Insurance assets may significantly increase the value of a company. In certain instances, unforeseen liabilities have far exceeded the value of a company purchased, and only its insurance coverage has prevented disaster.

For example, enormous unforeseen environmental and product liabilities may emerge years and even decades after a merger or sale. Fortunately, while old liabilities seem to never die, the same is often true of old insurance policies. A key component of most standard commercial general liability (CGL) policies is that, in a very real sense, they never expire. If a claim is filed against a policyholder thirty, forty or even fifty years after exposure to a product or toxic substance occurs, decades worth of policies may potentially respond. Older policies are extraordinarily valuable because they typically have few coverage exclusions and no aggregate limits of liability for certain categories of risks.

A target company's insurance assets should be evaluated before the transaction is completed for two important reasons. First, the insurance assets may affect the value of the entity being bought or sold. Second, the merger or acquisition agreement should define the rights and obligations of the parties to those insurance assets in order to avoid disputes when liabilities arise later.

The Pre-Purchase Insurance Audit

The process of evaluating a target company's insurance assets begins with a complete historic coverage audit. The buyer can retain experienced insurance archaeologists as part of its due diligence team and will need full cooperation from the seller. Indeed, the seller may be induced to perform the audit itself, since doing so could augment is saleable assets. A comprehensive audit will uncover more assets, preserve evidence and ensure greater protection for decades to come.

The first step in the audit is to establish a corporate history for the target company. Identify all former owners of the company and note the dates of changes in the corporate history, including significant acquisitions. Then, obtain copies of all existing liability insurance policies for each entity and identify gaps in the record of coverage. Interview current insurance personnel before the transition occurs to determine what they recall about past coverage and records retention. Finally, investigate records in storage and arrange to have records preserved.

Asset Valuation

After identifying the target company's potential liabilities and acquiring all available documentation regarding insurance coverage, the net impact of the liabilities upon the acquiring entity can be determined. Performing this analysis requires answers to the following questions:

1. Which of seller's insurance policies respond to these liabilities? Corporations typically have several types of insurance. CGL policies provide broad coverage for a variety of third-party liabilities. A standard insurance program also typically includes directors and officers, errors and omissions, employment practices liability, professional liability, automobile, and Workers' Compensation policies.

2. Do these policies contain any unusual terms, endorsements or exclusions that restrict coverage? Although most insurance policies are written on standard forms, customized or "manuscript" policies may contain unusual terms or conditions, and even standard form policies may be altered by endorsements limiting coverage or excluding certain types of risks. These endorsements can be warning signs of liabilities that may not have been previously disclosed or suspected.

3. Is coverage exhausted under aggregate limits of liability? Coverage may be exhausted under liability policies that have aggregate limits for particular risks or hazards. In that case, excess policies sitting above the exhausted policy—if any—must be looked to.

4. Do the policies provide real coverage? Primary policies may have high or uncapped deductibles, retrospective premium programs and self-insured retentions which result in the policyholder retaining liability for the majority of the losses it incurs. Fronting policies or policies placed with captive insurance companies can also translate into "no coverage."

5. What law is likely to apply to these liabilities, and what is the current state of the law with respect to this type of claim? Insurance law varies by jurisdiction, and is crucial to determining allocation of liabilities among insurance policies.

Once these questions have been answered, projected costs for each type of claim can be allocated among the triggered policies to determine the likely value of the insurance assets. Costs are assigned to each policy period using a formula that can be relatively simple or extremely complex, depending on the policy terms and the allocation law in the jurisdiction. Costs are first allocated to the deductible, self-insured retention or retrospective premium, if any. Remaining costs are allocated to the primary policy, up to a maximum of the policy's per occurrence and aggregate limits. Any additional costs are allocated up through the umbrella and excess policies. The completed spreadsheet will provide the potential recovery for each type of liability claim under the seller's insurance program. Those figures should be discounted to account for the possible application of policy exclusions to claims, uncertainty on the law applicable to insurance coverage issues, and the possibility that litigation will be required to secure payment from the insurance companies.

Assigning Rights and Liabilities

In addition to determining the value of insurance assets, an insurance audit can identify problems that may arise when the acquiring company attempts to collect under those policies. Often, two or more surviving entities have the right to claim under the same historic insurance policies after a merger or acquisition. This is the case when the entity being acquired or merged shared coverage with another entity that retained its identity. The transaction agreement should clearly spell out the rights and responsibilities of the surviving entities under those policies. Issues to be addressed include the right to claim under the policies, particularly where coverage is provided under "fronting" policies that are reinsured by the seller. The seller may be unwilling to be the insurer for the very liabilities it is selling! The contracting parties should also spell out who has the obligation to pay deductibles, and retrospective, reinstatement or renewal premiums, when the buyer claims under the seller's policies.

If these issues and other issues are not addressed at the time of the merger or acquisition, liabilities which arise later can create difficult and costly issues. ■

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