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Mergers & Acquisitions
Don't Forget the Hidden Asset - Insurance

By R. Mark Keenan, Esq. and Mark Garbowski, Esq.

Last month the Wall-Street Journal reported that abundant credit and laxer antitrust enforcement is creating a wave of global "megamergers." *Blizzard of Deals Heralds an Era of Megamergers*, WSJ page A1, June 27, 2006. Insurance policies represent a significant asset class that is often overlooked by the people putting together such deals. Deal makers typically spend a great deal of time negotiating the transfer of historic liabilities but little or no time on the insurance policies that will cover any pre-closing liabilities assumed. Whether the acquired company has liabilities resulting from securities transactions, financial activities, environmental damage, toxic torts, or professional activities such as healthcare, its insurance policies represent an important source of potential recovery for those losses.

A Matter of Due Diligence

Your first task is to ask your negotiating partners for insurance policies and loss history data. Be aware that a company that is or was a subsidiary might be insured under at multiple insurance programs: its own program, its parent's program, and possibly that of additional companies that were previously part of its corporate history.

Other research tools available to you are the legal research databases (Lexis and Westlaw) and Mealey's Insurance Reports. Use these information resources to see whether the company you are purchasing, or any of its affiliates, has ever sued or been sued by its insurance companies.

The second step for your due diligence team is to analyze the policies and information you find. The most important areas of inquiry are:

- Are the policies claims-made or occurrence based?
- How much of the coverage is real: check for high deductibles, front policies, captives, or retrospective premium programs.
- What is the current status of exhaustion of the policy limits, if any, and progress to reaching maximums on retrospective premiums and deductibles? Were any retrospective premium programs closed?
- Are there any unusual exclusions? This may alert you to undisclosed

liabilities.

- If the insurance program is claims-made for recent years, what claims have been made? In particular, were any integrated or batch notices given under those policies?

- Has any coverage been settled or commuted, so that it is no longer available?

- How much of the coverage is with insolvent insurance companies, or companies whose long term financial viability is in doubt?

The third step is to bring the conclusions resulting from the insurance due diligence to the deal makers. This is a dollars and cents analysis and should be separated for each area of liability that the buyer and seller are negotiating. The team should predict the insurance recovery for each category of claims by creating one or two model claims for each category and evaluating which policies would cover the liability and how much will be uninsured (or "a gap"). With respect to potential future claims, to be of greatest use, the team should make these predictions using three scenarios: (1) nuisance claims, lots of defense costs and no indemnity; (2) moderate liability; and (3) catastrophic liability, essentially a "bet the company" size liability. The highest liability and greatest gap frequently is used to assess the transaction conservatively. The other due diligence teams may have made predictions about future liabilities which should be considered as well.

Using this information, your negotiators can make a far more intelligent decision about which liabilities to accept and to what extent. For instance, if the seller claims that his company's liabilities will never reach catastrophic levels, then you might ask for an indemnity for any liabilities above a set level for which your company cannot recover from insurance. Moreover, where the seller has been able to produce only a small fraction of the insurance that it could have and should have had, you might ask that company to retain a portion of the potential liability, reflecting the number of uninsured years. Where feasible, the team might suggest that the those obligations be secured with a new insurance policy, perhaps a finite risk policy with a risk transfer component, or one written out of a captive. Who pays the premium can be negotiated.

In addition to these areas for creative input, the team also can give important nuts and bolts advice on a number of other insurance-related issues:

- Ensure access to the seller's insurance program for the recent years. This is a particularly thorny issue where part of the program is a captive.

- Are there any premium refunds due to the company you are purchasing? Again, in captive and finite risk programs, the subsidiary that you are acquiring might have made substantial investments. Your team may recommend leaving the funds with the selling parent in return for future access or recapturing the funds and placing them in your own insurance vehicle.

- If your company ever makes claims under the selling parent's policies, who pays the resulting deductibles, retrospective or reinstatement premiums? While it may be relatively easy to agree to pay retrospective premiums, much care should be taken before agreeing to pay any reinstatement or renewal premiums. As a stranger to the selling parent's insurance program, you never will know with certainty whether the allocation is fair or not.

- If the insurance program was claims-made, should your company give notice of any claims before the end of the current policy period? Should you buy an extended reporting period or separate tail policy? Who should pay for it?

Making the Best of a Bad Situation

If you are faced with learning of the acquisition after the deal is done, steps can be taken immediately to protect your company in the future. The first thing to do is to find any long-time employees of the company you acquired who may have been involved in or knowledgeable about any relevant insurance programs. Do this quickly, before engaging in any related downsizing. When you find such persons, debrief them on where any old policies, claims files or the like might be found. Do the same with the brokers. The results of these interviews and any documentation found should be put in safe-keeping, with all of your company's other insurance policies.

If your company is sued for alleged pre-acquisition liabilities of the company it acquired, you must send notice to all of that company's historic insurance companies that you have found. You should also send a letter to any prior owner of the company you acquired - not just the company that sold it to you - and demand that they put all of their relevant insurance companies on notice of these claims immediately.   This might put your company in competition with the prior owners of the acquired company for insurance assets. Where two companies are claiming under the same policies, there may be no problem if the policies do not have aggregate limits applicable to the claims. However, where there are applicable aggregate limits the rule generally is, first come, first served.

In sum, don't forget your insurance assets and use a knowledgeable team to "perfect" your interest in those assets.

R. Mark Keenan is a senior shareholder in the New York office of Anderson Kill & Olick, P.C. and chair of the firm’s Financial Institutions Group. Mr. Keenan is a leading lawyer in the fields of insurance coverage, securities law and litigation. Mr. Keenan regularly represents policyholders in insurance coverage disputes involving broker/dealers, hedge funds, investment advisors and other financial institutions.

Mr. Keenan can be contacted by phone at (212) 278-1888 or by email at mkeenan@andersonkill.com

Mark Garbowski is a senior shareholder and member of Anderson Kill & Olick's insurance recovery group, with particular experience in professional liability insurance, directors and officers (D&O) insurance, fidelity and crime-loss policies, internet and high-tech liability insurance issues.

Mark Garbowski can be contacted by phone at (212) 278-1169 or by email at mgarbowski@andersonkill.com

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We hope that you have found this Alert informative. We invite you to contact the editors listed below with your questions and/or concerns:

R. Mark Keenan, mkeenan@andersonkill.com, 212-278-1888
Mark Garbowski, mgarbowski@andersonkill.com, 212-278-1169
Craig M. Hirsch, chirsch@andersonkill.com, 212-278-1470
