The Hidden Value of Historic Insurance Coverage

by Robert Horkovich and Diana Shafter Gliedman

Among the many risks associated with mergers and acquisitions, the legal liabilities of the target company loom large. Accordingly, due diligence teams with legal, financial and technical expertise can spend months poring over databases and documents in an effort to identify the liabilities and assets the company may be procuring. All too often, however, due diligence teams fail to account for what can be a company's most valued asset: its historic insurance program. Insurance policies, sometimes decades old, can provide vital protection for liabilities that emerge after the transaction is completed. They may make the difference between a deal that can be done and a deal that falls through.

The value of a company — and the advisability of acquiring that company — cannot be properly assessed without a thorough understanding of the historic insurance assets available to cover future losses, often for past liabilities. Due diligence teams should therefore include a risk manager and/or other insurance professionals who can analyze the availability of coverage for future liabilities.

Unraveling the History

The first step in the insurance due diligence process is to establish a corporate history for the target company. The due diligence team should identify all former owners of the company and note the dates of changes in the corporate history, including significant acquisitions. The team should then identify all existing insurance policies for each entity and identify gaps in the record of coverage. The team should also speak to brokers (past and present), investigate records in storage and arrange to have records preserved. This significant undertaking should take place before the transaction is done, when interest in the deal is high, and not afterwards, when employees of the newly acquired company may be more interested in polishing their resumes than answering questions. To the extent it is not possible to obtain a complete picture of the company's historic insurance assets, the services of an insurance archaeologist may be needed to locate lost policies.

It is not enough to identify all of the policies that list the target company as a named insured. A good due diligence team will also identify other companies that can make claims under the target company's historic insurance program. This may include companies or subsidiaries that have been sold or spun off, or entities listed or qualifying as "additional insureds" under these policies. You do not really know what coverage is available if you don't know how many other entities may lay claim to it.

Understanding Your New Potential Liabilities

In addition to creating an inventory of the target's insurance assets, the due diligence team should also identify the target's potential future liabilities. Potential environmental liabilities, product liabilities, toxic tort claims, employment issues and other risks must all be explored to determine the nature and scope of the target's liability exposures. This analysis requires a detailed understanding of the target company's historical operations, its products and services, the locations of its facilities, and the potentially hazardous materials it used. The team can then ascertain what coverage is required for the exposures they may take on—and whether that coverage is available under the target company's existing insurance program.

Reading, Reviewing and Analyzing the Available Coverage

A pile of policies may provide information about the coverage that was available when the insurance coverage was first sold, but it may not provide a clear picture of the coverage available now. The due diligence team must determine which policies have been eroded or exhausted due to previous claims; which policies may have been commuted or "bought back" by as a result of previous settlements; and whether any policies initially intended to provide coverage on an occurrence basis have since been converted into claims-made insurance policies. Policies should also be reviewed for any unusual or troubling exclusions, endorsements or limiting clauses, the existence of aggregate limits for particular types of claims, whether defense costs erode the limit of liability or fall outside limits, and whether the policies provide claims-made or occurrence-based coverage. All of this information will help the due diligence team value the policies once they are identified.

The team must also ascertain whether the insurance policies provide real coverage. Many primary insurance policies appear to provide meaningful coverage, but in fact do not. Through various constructs, the coverage afforded under a policy may be given back to the insurer. For example, retrospective premiums require the policyholder to reimburse the insurer for payments on claims, sometimes with an added claims handling fee. Similarly, a "fronting policy" may be designed to provide little or no coverage through the application of very high deductibles or self-insured retentions.

Valuing the Transaction

Once the due diligence team has done its best to evaluate the target company's future liabilities and available insurance coverage, it can provide an informed opinion as to how to structure the proposed deal. If it appears that the target company brings with it a significant risk of incurring moderate to serious liability down the line, and lacks sufficient insurance to cover those liabilities, the acquiring company may wish to rethink the purchase or, at least, adjust the price of the target company to reflect the risk. In this way, the team can ensure that the company is protected — or at least, insured.

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