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Insurance Due Diligence in Mergers, Acquisitions and Spin-Offs

By Mark Garbowski


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Insurance policies represent a significant asset class that is often overlooked by the people who work on mergers, acquisitions and spin-offs. Insurance professionals — usually risk managers and attorneys — are an often overlooked human asset that can help their employers and clients protect themselves when making such deals.

Insurance: A Matter of Due Diligence

When acquiring or merging with another company, your first task will be to ask your negotiating partners for insurance policies and loss history data, and possibly to have that same information organized and available on your side. Be aware that a company that is or was a subsidiary might be entitled to coverage under multiple insurance programs: its own program, its parent's program, and possibly those of additional companies that were previously part of its corporate history.

Other research tools available to you are the legal research databases (LexisNexis and Westlaw) and Mealey's Litigation Report. 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?
- Are there high deductibles, front policies, captives or retrospective premium programs?
- What is the status of exhaustion of limits?
- Similarly, has there been any progress toward reaching maximums on retrospective premiums or deductibles?
- Are there any unusual exclusions? These are often added by insurance companies in response to an extreme or unusual loss experience, and might alert you to undisclosed liabilities.
- If the insurance program is claims-made, have any integrated notices, notices of circumstances, or notice of potential claims been given under those policies?
- Also for claims-made policies, determine how much of an extended reporting period is included with the policy, and consider whether it might be worthwhile to purchase an additional extended reporting period, extended discovery period, or even a special

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policy — sometimes called a "tail policy" or "sunrise policy," designed to cover new claims that arise for historical pre-merger activities.

- 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 an analysis that 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, with lots of defense costs and no indemnity

2. Moderate liability

3. Catastrophic or "bet the company" size liability

Using this information, your negotiators can make a far more intelligent decision about which liabilities to accept. 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. 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 those obligations be secured with a new insurance policy, perhaps a finite risk policy with a risk transfer component. The allocation of premium cost can be negotiated.

Your team also can give important advice on a number of other insurance-related issues:

- Ensure access to the seller's insurance program for 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 will never know with certainty whether the allocation is fair or not.

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- If the insurance program was claims-made, should your company give notice of any claims before the end of the current policy period?

- How best to effect the assignment of the policies? An express transfer spelled out in the agreement is best. There is a common rule that insurance policies travel with the liability, but its application is less certain than an express provision in the papers. In addition, many policies will have a "no assignment" clause. While these are usually not enforced for existing liabilities, check the law in all potentially relevant states and consider seeking approval in advance.

Cleaning Up After the Fact

If you learn of the acquisition after the deal is done, you can still act 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.

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.

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Arbitration in Insurance Coverage Disputes: Pluses and Minuses

By Peter A. Halprin

Policyholders may be surprised to find that their insurance policies contain an arbitration provision. Deciding whether to proceed with arbitration, either after the denial of a claim or when procuring the placement of a policy, requires an understanding of the advantages and disadvantages of arbitration.

The Perceived Advantages of Arbitration

Although there are many definitions, arbitration has best been described as:

> A process by which parties consensually submit a dispute to a non-governmental decision-maker, selected by or for the parties, to render a binding decision resolving a dispute in accordance with neutral, adjudicatory procedures affording each party an opportunity to present its case.*

Broadly stated, there are a number of perceived advantages to arbitration over litigation, which include finality, enforceability, party autonomy and procedural flexibility, and neutrality.

Finality: Finality refers to the general absence of extensive judicial review of arbitral awards. As a general rule, the decisions of arbitrators are final and binding. The benefit of limited appellate review is a reduction in litigation costs and delays.

Enforceability: This is particularly valuable in the context of international arbitration as it is generally easier to enforce foreign arbitral awards than foreign court judgments. This is due, in large part, to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, which provides for mutual recognition and enforcement of arbitral awards by contracting states, and limits the defenses that may be raised in opposition to the confirmation of an award, the goal being to eliminate litigation following an arbitration.

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Party Autonomy and Procedural Flexibility: Arbitration facilitates party autonomy in that it allows parArbitration facilitates party autonomy in that it allows parties broad freedom to agree on the laws, procedures and rules applicable to their disputes.

Neutrality: Party autonomy is understood to open a space for neutrality of venue. In arbitration, the parties can potentially avoid concerns about the potential biases associated with going to court in the home jurisdiction of the other party.

Additional perceived advantages of arbitration include the confidentiality of the procedure (depending on the jurisdiction and stage of the proceedings), the reduction of forum shopping and parallel lawsuits, maintenance of the parties' business relationship, and cost and speed.

The Perceived Disadvantages of Arbitration

The perceived disadvantages of arbitration represent the flipside of the advantages. Finality and enforceability can limit a party's recourse in the event of an unfair decision. Party autonomy and flexibility, as well as neutrality, may result in a lack of legal protections, which typically hurts the weaker party (which lacked the bargaining power to select the procedure applicable to the dispute when negotiating the agreement). Confidential proceedings limit a party's ability to obtain precedent from a favorable ruling and to use statements made in the arbitration against a party at a later date. As to cost and speed, these advantages may be limited in complex proceedings.

The disadvantages can be particularly pronounced for policyholders (see, "Arbitration of Insurance Coverage Disputes: A Policyholder's Definitive Survival Guide," *The John Liner Review* (Fall 2010)). In particular, arbitration clauses in insurance policies are often drafted to benefit the insurance company (see, "Arbitration Clauses Can Make Dispute Resolution Arbitrary," *The Metropolitan Corporate Counsel* (July/August 2014)). For example, some arbitration provisions in insurance policies eliminate *contra proferentum*, the principle that language deemed ambiguous should be construed against the drafter (generally the insurance company) and in favor of the policyholder.

Negotiating Arbitration Provisions

If policyholders prefer arbitration, or are unable to avoid it, they can take advantage of the perceived benefits. For example, if an arbitration clause permits the policyholder to select an arbitrator, the policyholder can get the benefits associated with the selection of a neutral party with subject matter expertise. This means that the outcome will be decided, at least in part, by someone with dispute-specific expertise, something that is not guaranteed in court.

As a result of the disadvantages described above, some policyholders find it prudent to avoid arbitration entirely. This is best achieved through the purchase of insurance that does not contain an arbitration clause. Waiting to challenge a clause until after a dispute arises is difficult, as courts favor arbitration and often look for ways to enforce such agreements.

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*Gary B. Born, *International Arbitration: Law and Practice,* at 4 (Wolters Kluwer, 2012)