Axis Insurance Services, LLC

Managing Insurance Coverage During Mergers & Acquisitions

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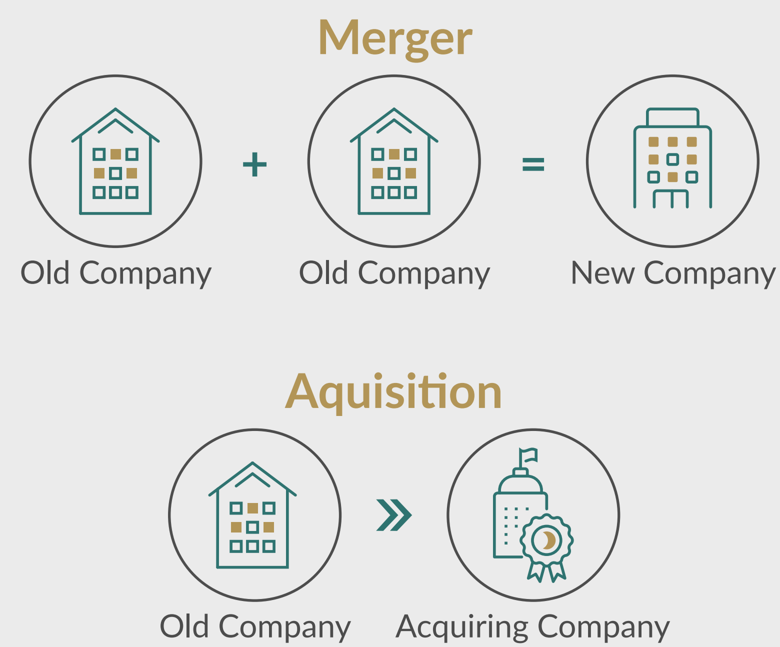
Mergers and acquisitions (M&A) activity reached an all-time high in 2021. The number of announced deals was up 24% from 2020—exceeding 62,000 deals globally.[1]

With each new consolidation, there's always some level of company due diligence that takes place prior to and during a corporate merger or acquisition. However, there are important facets other than EBITDA or cash flow, like insurance coverage, which tend to be overlooked.

This paper addresses specifically **Professional and Management Liability issues to consider in a merger or acquisition**. For any business or professional services firm with a professional or management liability insurance policy in place, not being aware of the coverage implications during a merger or acquisition can impact both companies as they move forward and could lead to disastrous results.

Mergers and acquisitions occur for many reasons. Here are some of the most common ones:

- To grow or enhance current products or services
- To complement a business strategy
- To control market share (buying out competitors)
- To buy companies with more efficient operations
- To consolidate operations
- To avoid Chapter 11 bankruptcy or erase company debt
- To assure perpetuation of a partner's financial interests



[1]PwC, "Global M&Q Industry Trends: 2022 Outlook."

Understanding M&As

What Is a Merger?

In a merger, two separate companies are brought together to form a single new entity.

Mergers are relatively common. They involve shareholders swapping stock of one company for another.
Even in the best of mergers, one company survives while the other dissolves—resulting in disgruntled shareholders on either side.

Often, one or both companies' stocks are surrendered and a new company stock is issued in its place. The new company is typically referred to as NEWCO and the acquired company or the one dissolved is referred to as OLDCO. NEWCO may own the shares of either company, or the two previous companies may surrender their shares. OLDCO is often dissolved but the liabilities of the shareholders or partners remain.

What Is an Acquisition?

Just like a merger, an acquisition occurs when a company is seeking to change or enhance their economies of scale, market visibility, or simply when shareholders want to sell out. During an acquisition, one company takes over another and clearly establishes itself as the new owner. The transaction can be with cash, stock, a combination of cash and stock, or one company simply acquires the assets of another company. From a legal point of view, the target company may cease to exist or continue as an operating subsidiary of the other company.

Why Is Insurance Coverage Important During a M&A?

M&A activity is rampant today in almost every sector. As companies are performing their due diligence—evaluating their EBITDA and cash flows—they often omit the insurance discussion until it's too late.
For any business or professional services firm with a professional management or cyber liability insurance policy in place, not being aware of the coverage implications during a merger or acquisition can impact both companies as they move forward. Lack of proper insurance can lead to uncovered claims and uncovered indemnifications that were not contemplated in the original merger transaction.

In this document we have highlighted several issues that need to be considered when evaluating insurance issues in an M&A transaction.

M&A Transition Insurance Checklist

When a merger or acquisition is in progress, both companies involved in the transaction should consider reviewing or updating the following:

01

Schedule of Insurance

You should prepare a schedule of insurance outlining all insurances, effective dates, expiration dates, limits, deductibles, premiums, and who is/isn’t insured under the policies. This will help both parties understand what is currently covered and not covered and what limits are currently in place.

02

Adequacy of Limits and Coverages

When merging two entities, often there are philosophical differences on insurance. It is important to determine if the limits, deductibles, and annual costs of separate limits are still appropriate for a larger combined entity or if additional coverages/limits are needed either prior to or subsequent to the acquisition/transition. Further, the systems and controls of a new entity might be different than the separate entities and therefore in need of evaluation. You should be prepared to see higher deductibles for larger consolidated companies.

03

Contracts and Agreements

A schedule of all third-party contracts should be prepared. This should include—at a minimum—contracts with vendors, third parties, cloud providers, independent contractors, and employees, among others.

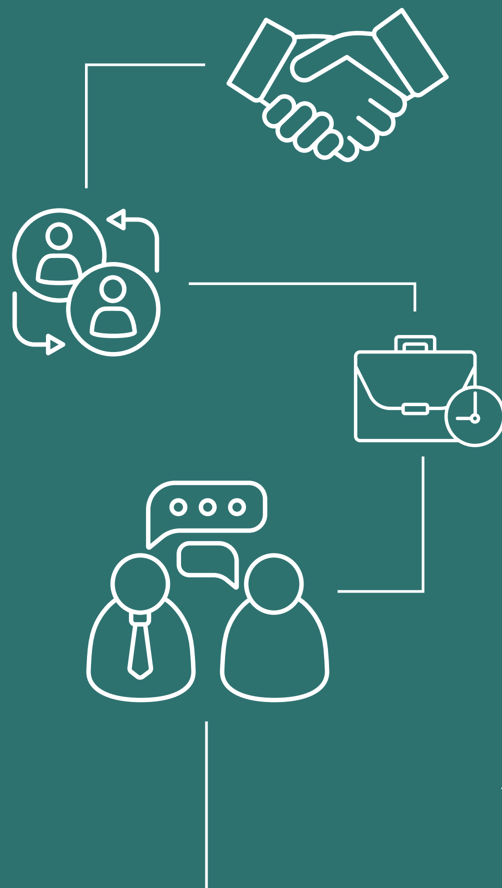
The contracts or agreements which exist in both companies must be investigated and updated to reflect the compliance standards of the new entity. Each party may be subject to third-party agreements which may have terms and conditions that can cause issues, such as non-transferability, extended reporting and contractual liability, additional insured status, and even ownership of client lists. These contracts can be between vendors, third parties, independent contractors, employees or others. Most contracts are not transferrable. Additionally, both companies may have contracts with the same third-party vendors and therefore will need to be evaluated.

04

Employment Practices and Contracts

In most cases, both the old and new company will have different policies and procedures when it comes to employment-related matters. Certain employees may have contracts that allow them to terminate non-compete or non-circumvention agreements. In other cases, since OLDCO may cease to exist, any existing contracts may not be enforceable by the NEWCO.

The NEWCO may need to resize—leading to terminations or reassignments for personnel—or otherwise change current working conditions. It's important that the acquiring company has a good understanding of the employment environment and consistently applies new policies and procedures to all employees in the transition. Any potential issues either company believes should be reported to the EPL carrier should be done prior to the date of the closing. The new carrier will most likely not cover any previously known events.



05

Claims-Made Issues

Most professional, management and Cyber liability policies are written on a claims-made basis. This means that they only cover claims "made" against the insured during the policy period or the extended reporting periods that may be automatic or reported.

One issue is that although these policies allow for reporting "incidents" during the policy period, there typically isn't any provision for reporting incidents after the policy period or during the extended reporting period (tail policy period or ERP). Many issues that are known to the seller prior to the date of sale, but the seller didn't believe rose to the level of a "claim" under the policy, come to light shortly after acquisition. This can create problems as noted in the Employment Practices section above in that known matters can be excluded under the new policy and be subject to late notification on the OLDCO policy. A detailed review of any potential litigation, errors or omissions or threats of litigation should be reported prior to the expiration of any policy or the merger date.

06

Insurance Policies

Neglecting to consider policy term dates and other important account updates could result in uninsured losses. A newly formed entity may be in a better financial position after a merger or acquisition; however, to remain protected from liability, changes will need to be made to the NEWCO's insurance coverage.

Every insurance carrier must be notified in advance of the acquisition, as some policies may terminate. We have highlighted below some common issues with professional and management liability insurance policies in a merger and acquisition transaction.

Change-in-Control Policy Provisions

Most insurance policies have a provision that describes what happens in the event of a change-in-control or management of the company.

In general, coverage will usually cease as of the date of the change-in-control (i.e., sale of a majority of the stock, merger representing more than a certain percentage of the stock, or even a termination of operations or a change in board control). It is extremely important that each policy is reviewed to determine what coverage is in place. We have seen many cases where claims-made policies are terminated and the acquired company must purchase a "tail policy" that was not contemplated in the cost of the acquisition. Often a carrier will waive a change-in-control if Operations and/or Management remain in place. However, such a waiver is not automatic or guaranteed.

Under claims-made insurance programs, the policy that is active on the day of the lawsuit or the claim is "made" against the company responds, rather than the insurance policy that was active the day of the incident or occurrence.

Issues may arise, however, if a policy is cancelled upon an acquisition or divestiture and a lawsuit is brought in the future (for example, one year later). In these circumstances, an Extended Reporting Endorsement (ERP) is required.

Similarly, asset-only transactions where liabilities are not passed to an acquiring company may also raise concerns.

Examples of Change-in-Control Provisions

Whenever there's a shift in corporate ownership, it will impact a company's insurance coverages. On average, if there is a change of between 25 to 50% of the voting stock, change-in-control provisions will apply to most insurance policies. Drastic changes in the share of control could lead to a termination of the company's insurance policy.

Below are some examples of change-in-control provisions in professional or management liability policies:

- The policy termination is effective immediately and will not cover any claims for services provided after the acquisition date.
- The policy remains active until its expiration date and will not cover any claims for professional services after the date of the change in control.
- The policy becomes paid in full. This means that there will be no returned premium if the policy is cancelled. This is especially important because most carriers will allow the insured to use unearned premium to offset the cost of an extended reporting endorsement. In this case, there would not be any returned premium.
- Insurance policies may only allow purchase of an extended reporting endorsement if the carrier cancels or non-renews the policy; or if the policy has been active more than a certain period. An insured may not have the ability to purchase an extended reporting endorsement in the event of a sale, merger, or simply closing their business. This consideration should be made before structuring the ultimate sale or merger agreement and any indemnity agreements.
- The insured only has a specific amount of time to report the change in control to the carrier and pay premiums relating to any extended reporting endorsement. Failure to report the sale/merger to your carrier within the time period (typically 30 days), results in the insured being unable to purchase an extended reporting endorsement. This means there will not be any coverage available to pay claims reported in the future that may have occurred during the policy period.

Keeping Your Broker Informed

Some carriers may accommodate a change-in-control, even if the policy says otherwise. It is best to notify the carrier/broker at the earliest point possible, so you know of any issues or additional costs. **With Professional Management and Cyber Liability insurance, there are certain provisions which companies and investors should be aware of.**

01

Extended Reporting

Standard Professional Management, and Cyber Liability Insurance policies typically provide an extended reporting endorsement (ERP or Tail Policy) for purchase. If additional coverage is purchased, an insured can report claims in the future for wrongful acts that occurred after the retroactive date of the policy and prior to the date of the acquisition for a certain period. This additional time to report a claim is purchased in 12-month increments typically ranging from 12 to 60 months; with the most common being 36 months. The cost of the additional time to report claims averages about 100% of the expiring premium for 12 months to 200% or 250% for 36 months.

From the acquiring company's standpoint, the Tail Policy serves as collateral for future losses that may come due to the acquired company's activities prior to the date of acquisition. An indemnification is only as good as the individual or company backing the indemnification. In an acquisition situation, because the OLDCO will most likely close, there will be no assets to indemnify or protect partners or shareholders from either company. That is why we recommend at least five years for an ERP.

02

Insured Entities and Predecessor Companies

The acquiring company will typically add coverages for the acquired entity on its own policies. It is imperative that the NEWCO work closely with the broker and the OLDCO to ensure that the policy provisions, named insureds, additional insureds and covered professional services are properly listed on the new policy.

Often, companies that were acquired or sold in the past are not listed on the new policy and are subject to future uncovered claims. A specific list of all companies, DBAs, additional insureds and predecessor companies should be provided to the new company and its broker. Most frequently, the current insurance carrier will add the NEWCO retro inception, so it will only cover claims that occur on or after the date of acquisition.

Keeping Your Broker Informed cont.

Professional Services

Each company is unique and so are their professional liability insurance policies. When moving E&O coverage to the NEWCO, it is imperative that the full scope of professional services of the OLDCO be taken into consideration. We often find that the OLDCO's E&O policy is less comprehensive, and the uniqueness of the professional services provided by the NEWCO is simply overlooked.

It is important to make sure that these professional services are covered under the NEWCO's E&O policy. Such nuances are often overlooked in the acquisition. As a result, most professional services companies have put contracts in place that require their coverage be maintained for a specific time after the contract period.

Entities/Divisions Acquired

In some acquisitions, only a portion of a company is acquired, raising issues regarding whether an extended reporting endorsement can be purchased for only a portion of the policy. Another issue to consider is whether liabilities will remain after a substantial portion of the company is sold. Depending on the nature of the business, any remaining operations must continue paying E&O premiums based on the combined entity for about three to five years. If the remaining company does not take this into consideration, they may have to continue paying for the risk of the entire entity after the sale.

Loss Experience

Review the loss experience of each policy in relation to the overall limits. It is possible that even if OLDCO might purchase a tail policy, there may be significant claims activity that could already exhaust limits. An Extended Reporting Endorsement (Tail Policy) only extends the time to file a claim that occurred during the period covered by the policy and does not provide additional limits. Often, additional limits can be purchased to cover prior claims. A current claim could already exhaust current limits. You should evaluate if the current policies are adequate to cover future risk. Often, additional limits can be purchased to cover the prior claims.

Keeping Your Broker Informed cont.

Reps and Warranties Insurance

In the acquisition process, the management of the acquired company must make many representations including current clients, estimated revenues, and contracts that are in place, including partner and employee contracts. Additionally, they should assess certain liabilities such as environmental exposures, regulatory issues, pending litigation, and on-going concerns. A buyer may require a Reps and Warranty policy to help insure against the validity of such representations by the potentially acquired company.

When evaluating Reps and Warranties insurance, there are several key considerations.

01 It's not cheap. Most carriers will require a minimum upfront fee of $30,000 to $50,000 just to underwrite the deal. Larger deals will cost even more.

02 The premium itself is usually a minimum premium of $150,000 to $250,000 per million. However, most deals are much more. Companies typically would not buy this type of insurance unless the deal size is greater than $50 million.

It's also important to consider that most Reps and Warranties insurance is sold to the buyer. Why? Because they are simply insuring against misrepresentations. There is an inherent conflict in buying a policy to protect against your own misrepresentations.

03 Retention often averages 1% of the enterprise value of the deal. This means that for a $100M deal you should expect a $1M retention.

04 Limits purchased are typically 10-15% of the deal size. (For example, a $100M enterprise value deal would generally require a $10-15M limit.)

Keeping Your Broker Informed cont.

07

Indemnification Provisions

Review the indemnification provisions of the purchase agreement. It is important to understand that the selling company will need to indemnify the acquiring company for future losses that might be related to the time they owned the company. Insurance helps mitigate the risk; however, the indemnification risks remain regardless of whether the insurance is adequate. Therefore, you need to consider the amount of time to purchase an ERP or Tail Policy.

Most sellers only want to buy what they are required to buy (typically three years). However, with or without the insurance they are still liable for indemnification. In most cases, the seller takes the money personally and is unable to indemnify the acquiring company, absent the ERP. We recommend most companies purchase a five-year tail.

08

Buyer/Successor Corp Endorsement

A suit against a seller always brings liability to a buyer even though they were not involved in the claim on the date of the wrongful act. If possible, we recommend getting a Buyer/Successor Corp endorsement for purposes of authority and notice. This could help defend the buyer company for your actions.

Although the above has not addressed every possible issue associated with a merger or acquisition, we believe it highlights some of the more important insurance issues to consider. Please feel free to contact Mike W. Smith at 201-847-9175 ext. 105 or msmith@axisins.com for any questions.

About Axis Insurance Services, LLC

Axis Insurance Services, LLC is a licensed Professional Management and Cyber Liability insurance brokerage located in Franklin Lakes, NJ with licensed insurance agents nationwide.

We offer customized professional liability solutions in the areas of Errors and Omissions insurance (E&O), Directors and Officers liability (D&O), Cyber Liability, Employment Practices Liability (EPLI), Privacy/ Network Security, Cyber Liability, Commercial Crime and Fiduciary coverage for today's professional services companies.

We serve all types of businesses, including real estate professionals, insurance professionals, third-party administrators, medical groups, architects, engineers, accountants, and many others.

For more information on Axis Insurance Services, LLC, visit www.axisins.com or call 201-847-9175.

About the Author

Mike W. Smith

Principal/CEO

Mike is the founder and President of Axis Insurance Services, LLC and PLRisk Advisors, Inc.—both nationally recognized Professional Management and Cyber Liability insurance brokerages.

Mike is a valuable market resource and is frequently requested as a speaker, panelist, and writer on professional and management liability risk and insurance. With over 35 years of experience in the industry, he brings a wealth of knowledge and a unique ability to create innovative coverage solutions.

In 1999, Mike founded Axis Insurance Services, LLC to provide customized Professional Liability solutions for business, and in 2012, he formed PLRisk Advisors, Inc. to create a presence in the wholesale E&O market. Today, both companies enjoy success across the areas of errors and omissions liability, directors and officers liability, cyber, commercial crime, and EPLI.

Formerly a CPA audit manager at Coopers & Lybrand (now PWC), Mike managed audit and consulting services for insurance and healthcare clients, including some of the nation's most well-known Fortune 500 companies. He specialized in mergers and acquisitions and insurance company liquidations. After dealing with hundreds of insurance companies, agencies, reinsurers, and alternative risk companies, Mike is able to provide valuable insight for the needs of his clients.

At Medical Inter-Insurance Exchange (MIIX), a medical malpractice carrier, Mike was responsible for assisting the company in mergers and acquisitions and development of numerous insurance programs. Later, as the Chief Financial and Operations Officer of a related company, he built a physician-owned insurance carrier from the ground up, including all hiring, systems development, licensing, and marketing.

Mike lives in Wayne, NJ with his wife and son. Mike volunteers with many civic and charity organizations including CUMAC Echo, Autism Speaks, and many others. He also enjoys scuba diving, fishing, and attending sporting events.

Accomplishments

- Certified Public Accountant, 1986 (inactive)
- Professional Insurance Agents Association Member (PIA)
- President of Eastern Chapter Steering Committee for Professional Liability Underwriting Society (PLUS)
- American Institute of Certified Public Accountants Member
- Founding member of FSU Seminole Club of the Delaware Valley
- B.S. in Accounting, Florida State University, 1984