

Commercial Insurance Update

Topics Affecting Buyers of Commercial Insurance

MSP C 08/2004 – “Mergers & Acquisitions—Insurance Implications”

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Mergers & Acquisitions: Insurance Implications

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Risk management and insurance-related issues are a critical aspect of any merger or acquisition. Unfortunately, many times these issues are overlooked and are not addressed until after a deal has been finalized. However, the benefits of evaluating risk management and insurance issues early are self-evident, and residual or assumed liability exposures should be negotiated as part of the purchase agreement.

You should be aware that insurance policies are not assignable. You will not necessarily be able to utilize the insurance coverage currently placed on a company after it is acquired, since the permission of the insurance company writing the coverage is required.

Evaluating the insurance program of a proposed acquisition will provide valuable insight into the overall operations and quality of the company being purchased. A firm that is a poor insurance risk or has an adverse loss history or experience modification may also be a poor business risk.

For these reasons and others, a thorough analysis of a company's risk management and insurance programs is critical to a successful merger or acquisition.

➤ **Risk Management Analysis** – Risk management analysis involves evaluating a company's entire operation to determine exposures to loss. The objective is to understand the firm's risk profile and avoid assuming unknown and potentially costly exposures.

➤ You should **involve your insurance broker** early. Your broker will want to review:

1. Complete copies of all current insurance policies.
2. Copies of the most recently completed insurance applications.
3. 10 year loss history.

In addition, in all likelihood the broker will want to have access to the existing broker for the company being acquired.

Mergers (continued on page 2)

In this issue...

Mergers & Acquisitions: Insurance Implications	1-3
Mergers & Acquisitions: Risk Management Questionnaire	3
Liability Limits: How Much Should I Carry?	4

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When evaluating an insurance program, the broker will determine whether or not it makes sense to retain the existing program or consolidate the program onto the *acquirer's* master policy. Consolidating insurance programs can often generate substantial savings.

Depending on the nature of the operation being acquired, however, the insurance company providing coverage for the *acquirer* may not be interested in assuming the exposures of the firm being acquired. In these instances, the existing program might be the only option, or another program may have to be set up.

A review of the most recently completed applications will provide your broker with a tremendous amount of information regarding the company, not only about the firm's business and risk management practices, but also its loss history. Underwriters evaluate these things carefully when determining the acceptability of a given risk.

Coverage Issues for Specific Policy Types

1. **Workers compensation** is a major consideration. Generally, the experience of an acquired company and the experience of the parent will be combined, and a new experience modification will apply. This can have a huge impact on insurance costs, and it is an issue that should be evaluated *prior* to an acquisition.

You should also determine whether or not the entity being acquired has been written on a retrospectively rated plan. Cancellation of such plans can result in heavy penalties. In addition, adverse loss experience can result in significantly higher premiums for years to come.

2. **Residual liabilities** are another huge issue. In some cases, a company may only buy another firm's assets. In a situation like this, the entity being acquired will need to arrange coverage for their residual liabilities. Depending on the type of coverage, this can usually be done with some form of an Extended Reporting Period (ERP) Endorsement.

If the parent company is also acquiring the liabilities of another company, those liabilities will have to be insured by the parent. In a situa-

tion like this, the parent may have to specifically endorse its policy to provide prior acts coverage for the company being acquired. This issue is critical, but is often overlooked.

3. **Directors and Officers (D&O) Liability Exposures** – Mergers and acquisitions involve a number of different parties. It is not uncommon for expectations to be unfulfilled, and it will come as no surprise that mergers and acquisitions often provoke stockholder lawsuits against directors and officers for any number of reasons.

Note that directors and officers liability insurance policies usually exclude coverage for the acts of a subsidiary's directors and officers that occurred prior to an acquisition date.

In addition, it may be necessary for an acquired company to purchase an Extended Reporting Period Endorsement to cover its residual liabilities under its D&O coverage as of the date the entity was acquired. Once again, coordinating directors and officers liability policies is critical.

4. **Representations and Warranties** – Every merger or acquisition involves representations and warranties made by one party to another, usually involving the seller's indemnity or escrow obligation to the buyer. The seller may also be required to put a portion of the value of the indemnification agreement in an escrow fund as a guarantee that its indemnification obligations will be met.

Several insurance companies offer "Representations and Warranty" insurance. The policy indemnifies an insured for loss due solely to "a breach of a representation and warranty" (an untrue, false or materially inaccurate statement of material fact). The policy does give an insured the right to subrogate against any party to the transaction.

Needless to say, there are a number of terms and conditions for this type of coverage, and the underwriting is also quite thorough. Regardless, this type of policy should be considered, especially if the representations and warranties are significant.

5. You can also purchase **merger and acquisition expense insurance** to cover a firm's outside expenses on a deal that didn't work out. Covered expenses include the fees of attorneys, accountants, stockbrokers and investment bankers as

well as the charges made by public relation consultants, proxy solicitors and advertising agencies. Coverage applies only if the deal fails for reasons specified in the insurance contract.

Whether your firm is merging with, being acquired by, or acquiring another firm, these deals create complex exposures to loss. Risk management and insurance analysis done up front can help identify those exposures and facilitate a successful transaction. ✨

Disclaimer: This article is written from an insurance perspective and is meant to be used for informational purposes only. It is not the intent of this article to provide legal advice, or advice for any specific fact, situation or circumstance. Contact legal counsel for specific advice.

Mergers & Acquisitions – Risk Management Questionnaire

Named Insured * _____

1. Name of Firm Being Acquired * _____
Address _____
Phone Number _____
Fax Number _____
E-Mail Address _____

2. Insurance Contact _____
Phone Number _____
Fax Number _____
E-Mail Address _____

3. Date of Acquisition _____

4. Did you acquire assets only or stock? Assets only Stock

5. Who will be responsible for the firm's prior acts? _____

- 6. Please attach the following:**
- Copy of current policy(ies)
 - Most recent insurance application(s)
 - Loss history (10 years if possible)
 - Copy of Buy-Sell Agreement

7. Has the firm you are acquiring made an inquiry of its staff to make certain that any claims or circumstances which could give rise to a claim have been reported to its current insurance company? ** Yes No

* (Include any other companies, entities or prior entities that should be included for insurance or ERISA bond purposes)
** This is critical on claims-made policies such as Professional Liability, Employment Practices Liability and Directors & Officers Liability.

Completed by _____ **Date** _____

Liability Limits: How Much Should I Carry?

By Jeffrey W. Cavnac, CPCU, RPLU
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One of the most common questions an insurance broker receives is “*How much insurance should I carry?*” Although the question pertains to just about any line of coverage, this article focuses on liability limits.

Liability insurance is designed to protect an insured from legal liability to third parties. It takes a number of different forms, including personal liability (generally part of a homeowners policy) auto liability, business liability, and professional liability – the list goes on.

There is no “right” answer to the question of liability limits. In the event of a catastrophic accident, any plaintiff’s attorney is going to go for policy limits, regardless of what they might be. There is some validity to the theory that the more insurance you carry, the larger a target you become.

The flip side is to carry no insurance, which in most cases is foolish and in some cases illegal. For most businesses, some minimum amount of insurance is either required by their landlords or by someone else they do business with. So what *is* the appropriate limit?

Four factors should be considered when evaluating your limits of liability:

1. **What is your maximum probable loss?** Note that this says the maximum *probable* loss, not the maximum *possible* loss. You cannot afford to insure for the maximum possible loss.

The maximum *probable* loss is dependent on a number of different factors, mainly on the type of the business. An amusement park, for example, would have a significantly higher maximum probable loss than would a retail store.

2. **What limits do your clients require?** Many times, especially for design professional and construction clients, limits of coverage are determined by their clients. You might normally carry \$1 million, but if your key client demands \$5 million, you buy \$5 million. Depending on the type of coverage, you may be able to purchase specific client excess or specific project excess,

and if done correctly, you will be able to incorporate the additional cost into your overhead. Regardless, client-dictated requirements are a material factor in the limits that a lot of our clients select.

3. **What limits do your competitors carry?** This serves as a barometer. If your construction company carries a \$1 million limit but all the other firms your size carry \$5 million, there is usually a reason.
4. **What can you afford?** Let’s face it, insurance isn’t cheap, and you can’t allow your insurance premium to put you out of business. Price will always be a consideration when it comes to selecting the right level of coverage.

So how much insurance should you carry? How high should your liability limits be? As previously indicated, there is no one “right” answer. By evaluating the four factors above, however, you should be able to develop a better idea of what limits are appropriate for your business. ✨

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