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Let's Make a Deal: Four D&O Coverage Issues to Consider in M&A Transactions

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Insurance coverage is an important, but sometimes overlooked, component of any M&A transaction. Many deal lawyers have a working knowledge of directors and officers insurance and how to protect businesses and decision makers in the event of a claim, but oftentimes insurance issues take a back seat to other aspects of transactions. As *In re Glasshouse Technologies, Inc* and other cases show, however, the devil is in the (insurance) details, and companies should not assume that the status quo will be preserved or that existing policies will offer adequate protection for current or future liabilities after closing. This article presents a brief overview of key insurance coverage issues to consider when structuring M&A deals to mitigate risk and maximize short- and long-term recoveries should a claim arise.

1. CHANGE IN CONTROL

One of the first insurance questions to ask is whether the particular deal or financial restructuring triggers a "change in control" under the company's current D&O policy, which typically includes an acquisition, merger, consolidation, or sale of more than 50 percent of assets. Whether this provision is triggered and, if so, when the change in control occurs matters because D&O policies will provide coverage only for wrongful acts that occur before the change in control occurs.

The change in control provision may also include conditions requiring that the company provide notice to the insurer within a certain amount of time to preserve coverage for the restructured entity. As with most insurance issues, the question of change in control is highly fact-specific and depends on the policy language and the details of the deal. For example, a series of sales to different entities may trigger a change in control if the buyers are acting in concert, even where no transaction involves more than 50 percent of the company's assets. Parties also may assume that if the reorganization or asset sale takes place as part of bankruptcy proceedings (typically Chapter 11), then the change in control provision is automatically triggered. However, some policies turn on whether there is an appointment of a trustee, receiver, or similar entity, which does not always occur.

2. "RUNOFF" AND "TAIL" COVERAGE

Deals often involve runoff and tail coverage, which depend on the policy's change in control provision and the effective date of the deal. If a change in control provision is triggered, it typically converts the existing D&O coverage to "runoff," which means that claims based on conduct after the change in control are no longer covered and that claims based on pretransaction conduct are covered through the end of the policy period. "Tail" coverage extends coverage for claims based on pretransaction conduct, usually for several years, and is available through endorsement (either automatically or by request, typically subject to payment of an additional premium).

Runoff and tail coverage terms generally turn on whether the claims are based on conduct before or after the transaction's effective date, but as the *GlassHouse Technologies* case shows, policyholders should not assume that the terms and conditions of those coverages will remain the same. The dispute in *GlassHouse Technologies* involved a broker's alleged errors in procuring tail coverage in connection with sale of GlassHouse's U.S. consulting business, which the broker viewed as potentially triggering the change in control provision in GlassHouse's existing D&O policy. To avoid any gap in coverage for pretransaction conduct, GlassHouse purchased tail coverage by endorsing the policy, but as GlassHouse later learned, the tail coverage endorsement not only extended the reporting period for several years, it also reduced the limits for the remainder of the initial policy period from $15 to $5 million. As a result, when one of GlassHouse's creditors asserted claims against the company's directors and officers shortly after closing during the initial policy period, those claims were subject to substantially reduced limits. The parties became embroiled in litigation regarding the actions of the broker in modifying the existing limits as part of the tail coverage endorsement.

3. PRESERVE EXISTING INSURANCE ASSETS

A surviving entity might not assume all existing liabilities of the company it is acquiring. In structuring M&A deals, buyers and sellers alike should be aware of the potential adverse impact limited transfer of liability (or assets) may have on the surviving entity's ability to access historic insurance assets or trigger coverage for legacy liabilities arising from pretransaction conduct. The right to claim coverage under legacy insurance policies may be extinguished if the liabilities of the policyholder were extinguished in a merger or acquisition.

The *BCB Bancorp v. Progressive Casualty Insurance* case illustrates this problem. In *BCB*, an insurance carrier withdrew its defense of a bank's premerger shareholder class-action lawsuit on the grounds that the directors' and officers' rights under the policy terminated when the policyholder dissolved and was consolidated with the surviving entity via a statutory merger under New Jersey law. The court rejected the insurer's argument based on the lack of an exclusion in the policy preventing transfer of rights to a surviving entity under the New Jersey merger statute. As the *BCB* case shows, the potential impact of M&A deals on D&O insurance depends not only on the policy language and terms and structure of the deal, but also on applicable state law. Another related issue is whether the insurance assets necessary to respond to a current or future claim were transferred in the deal.

4. COVERAGE FOR THE DEAL

Parties must assess a deal's impact on existing and future insurance policies, but there also may be ways to mitigate risk by purchasing insurance coverage for the deal itself. The most common example of this is representation and warranty (R&W) insurance, which protects a buyer or seller from losses arising from inaccurate representations or warranties made by the seller or target companies during the merger, acquisition, asset sale, or other transaction. A buyer-side R&W insurance policy, for example, protects the purchaser by paying losses if the target company presents inaccurate information, such as by misrepresenting or failing to adequately disclose a particular liability. These protections can often fill in the gaps if a seller offers little or no seller indemnity in the deal and provide a useful alternative to the traditional indemnity protections. Other types of deal-specific insurance (such as an environmental policy for a particular liability) may be available to mitigate risk.

TAKEAWAYS

With all of these issues, the particular risks and potential protections afforded by D&O and other insurance policies are dependent on the terms of the deal, the existing or contemplated policy language, the type of claims giving rise to coverage, and numerous other individualized issues (e.g., financial resources, risk appetite, business needs, applicable state law, etc.). As the *GlassHouse* and *BCB* cases show, there is no one-size-fits-all approach or foolproof checklist when it comes to M&A deals and insurance. Involving experienced coverage counsel, however, can help address important insurance issues, mitigate risk, and maximize potential recoveries. The time to do that is early in the deal process before due diligence concludes, the parties become entrenched, and the pressure to close increases.

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