

■ ANOTHER PERSPECTIVE

## Post-Merger D&O Cover Poses Unique Challenges

BY PETER TAFFAE

**O**NE LESSON CLEAR TO ANYONE who's been involved in insurance for decades is that time-honored coverages—even those seemingly as old as S&H Green Stamps—need to be examined and tailored to individual customer situations.

Directors and officers liability insurance runoff policies aren't quite that old, but the first one I wrote was for Sperry & Hutchinson, a company founded in 1896, which (for those not old enough to remember) ran a popular rewards program that some view as the precursor to today's frequent-flyer systems.

Well-known to U.S. consumers buying everything from groceries to gasoline from the 1930s through the 1980s, S&H sold stamps to retailers, who in turn gave them to customers as bonuses with every purchase. Collect enough and shoppers could use them to claim valuable prizes from the local Green Shield shop or catalogue.

Sperry & Hutchinson itself, after a long history in the business, became the victim of numerous securities lawsuits arising from a steep decline in the company's stock price.

In 1984, the company was sold. The current D&O underwriter wanted off the account and would not offer a six-year tail, as required by the merger agreement, allowing me to step in to offer terms after thoroughly underwriting the risk.

"Interrelated wrongful act" wording in our policy, the comprehensive allegations in the litigation and the likelihood that the litigation filed would be covered under the expiring D&O coverage were factors considered at the time.

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Twenty-five years later, working as a wholesale broker, we have placed hundreds of runoff policies representing acquirers as well as acquired companies. Experience has revealed a number of unique circumstances that need to be addressed, and many that are often overlooked when addressing the coverage of a D&O runoff policy.

### PROCEED WITH CAUTION

Starting in the early 1990s, D&O insurers amended their policies to include an automatic conversion to an extended reporting period upon a change of control (of the board) for the balance of the policy period following the change in control.

In other words, if a company that has a 12-month D&O policy in force is acquired midterm, the directors and officers of the acquired company are automatically covered for claims reported during the next six months for wrongful acts occurring before the acquisition date.

This is not enough, and additional time should be negotiated when securing D&O runoff coverage. This means more than simply buying a longer extended reporting period—extending several months beyond the automatic conversion period.

More suitable is a separate tail or runoff policy secured to extend the same type of coverage for wrongful acts occurring before the acquisition but reported during the reporting period—somewhere between three and 10 years, depending on the statute of limitations.

In addition to the length of reporting time, the issue of adequate limits needs to be decided early in the negotiation process. If the board was comfortable with \$10 million for an annual period, how much is adequate for a six-year period?

Often, clients request excess limits over the original limit to insure adequate pro-

tection post-merger. This can be challenging, but not impossible, if the primary limit is impaired because of claims. When appropriate, we have negotiated "reinstatements" to further insure protection against frequency and catastrophic events.

While studies (including one by Tillinghast-Towers Perrin) have suggested that one-in-three D&O claims arise out of mergers and acquisitions, if approached diligently, underwriters have a distinct advantage when writing the runoff of an acquisition target over everyday D&O risk underwriting.

The advantage is that the "photograph" does not change. There is a known beginning and known ending. Any and all

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Ten years ago, underwriters would not quote a competitor's D&O runoff—which has changed, in part, because of underwriters' attraction to the "still photograph" and potentially lucrative premiums. Six-year runoff premiums range from 1.35- to 2.2-times the annual.

The merger agreement becomes the most important underwriting and brokering tool. Specifically, the indemnification provision of the agreement will specify the required time period for the runoff policy—most often six years, but some are as short as three years, and others as long as 10 years. It also will often state coverage "no less" than currently in force.

It is critical that certain steps take place prior to a merger's close.

Since the primary objective is long-term protection of the acquired company's directors and officers, the policy must be noncancelable and earned at inception. This ensures the coverage cannot be altered or cancelled for any reason. (During the

days of frequent hostile takeovers, the new board would cancel the multiyear runoff for the return premium.)

This means the policy must be paid prior to the merger date, and the premium cannot be financed. Anything to the contrary violates the sole intent of this coverage—to protect the acquired firm's directors and officers from claims for pre-merger activities—and jeopardizes this valuable protection.

We have occasionally seen other brokers amend the prior-acts exclusion on acquired subsidiaries under the acquirer policy, thinking that the new subsidiary will be covered for past acts. There are a few prob-

lems with this approach. One is that there is an insured-versus-insured exclusion that now removes coverage for suits brought by the acquirer against the acquired.

There are a host of additional issues that require attention when structuring runoff coverage for acquired companies and ongoing coverage for acquirers:

- ▶ Is corporate reimbursement desired?
- ▶ Who does it benefit—the acquiring company or the target?
- ▶ Who are the named insureds? (The answers will likely depend on whether the old company will legally exist post-merger.)
- ▶ How will the “presumptive indemnification” provision affect coverage?

Under this provision, the insurer presumes the company will indemnify individual directors and officers to the maximum extent of the law.

As a result, any deductible that applies under the corporate reimbursement section of the D&O policy (insuring agreement B) may apply if a company is legally permitted to indemnify its directors and officers but fails to do so. That would mean that directors and officers might have to personally fund the deductible.

Finally, a broker will want to consider the pros and cons of having different insurers on the runoff and ongoing policy, and to outline these fully for clients. ■