The Deal
BYLINE

ARE YOUR M&A DEALS CREATING GAPS IN INSURANCE COVERAGE?

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Insurance policies often contain "change-in-control" provisions that restrict coverage, or even eliminate it altogether, as a result of changes in ownership. Deal lawyers need to make sure that their due diligence includes a review of these change-in-control provisions and that the insurers receive the necessary notifications to keep insurance in place, uninterrupted, and/or new coverage is secured. Failure to do so can create an unwelcome surprise for companies and their Board members when they are sued and come to find out that, because a few steps were overlooked in a deal, their insurance has an unexpected gap or has even been cancelled.

Insurance policies that contain change-in-control provisions typically insure against certain "wrongful acts," as defined by the policy, that the company or other insureds allegedly commit. Change-in-control provisions are generally triggered when ownership or control of a company has changed, whether as result of a merger, asset acquisition, or change in voting control. When a triggering event occurs, coverage under the policy immediately changes. The type of the change will depend on the specific policy language, but typically the policy will not insure wrongful acts that occur after the trigger event and will only insure wrongful acts that predate the change-in-control. Other change-in-control provisions will even terminate the insurance policy altogether.

The draconian impact of overlooking a change-in-control provision is illustrated in a lawsuit that was filed in New York Supreme Court, American Forest Holdings, LLC ("AFH") v. Marsh Commercial Business Center, by a company against its insurance broker for allegedly allowing insurance to lapse because a change-in-control provision was triggered but not acted upon.

As alleged in the lawsuit, an LLC was insured under a D&O insurance policy, which had a lengthy six year policy period from October 2006 through October 2012. In March 2007, the insured LLC merged into a newly formed LLC, AFH, with AFH as the surviving entity. Before the merger, AFH was a shell company containing no assets or liabilities, but as a result of the merger, AFH "was the ultimate successor entity to [the insured LLC] with identical owners and assets." However, the broker allegedly never notified the insurance company of the merger, never asked the insurer to add AFH to the policy, and never advised AFH as to the effect of the merger on coverage under the D&O policy.

The change-in-control provision in the D&O policy provided that when there is a merger or acquisition of an insured, the policy would only cover "wrongful acts" through the time of the change-in-control and would not cover any acts committed afterwards.

In 2010, Bank of America ("BOA") commenced an arbitration against AFH and, in 2012, BOA received an arbitration award. On the date of the arbitration award, AFH tendered the claim to the D&O insurer. Initially, the insurer questioned whether AFH was even insured under the policy and requested additional information regarding AFH's relationship to the insureds identified in the policy. AFH described the merger to the insurer, noting that AFH had the same assets, liabilities, and members as the insured LLC listed on the policy. However, the insurer denied coverage because the merger was a "change-in-control" under the policy, resulting in the exclusion of wrongful acts occurring after the 2007 merger.

Because the BOA arbitration was based on events occurring in 2010, the change-in-control provision barred coverage. The insurer also denied the claim because AFH was not identified on the policy, as the insurer never received notice of the 2007 merger. AFH sued Marsh for $20 million (the D&O policy limits) for failing to properly advise the company of the impact of change-in-control provision or notify the insurer of the merger.

The AFH v. Marsh lawsuit presents a stark example of how an oversight can create a massive problem – in that case a $20 million problem. The D&O policy had a policy period from October 2006 until October 2012, but the merger cut that off (for subsequent events) in May 2007. The parties' failure to understand the intersection of mergers (or other transactions) and insurance – or more precisely ignorance of the change in control provision – created a five and half year coverage gap that was not discovered until a large loss was incurred. This coverage gap could have been avoided through due diligence involving attention to the change-in-control policy provision and notification to the insurer.

Here are the key lessons that deal lawyers can learn from the mistakes alleged in AFH v. Marsh:

Change in Control Provisions Have Consequences.

The change-in-control provision in the D&O policy was a fairly typical one, excluding wrongful acts occurring after the ownership change while still covering acts that predate change in control. Some provisions can be even harsher, terminating coverage altogether. Awareness of these potential pitfalls when negotiating deals is the first step to ensuring that the necessary coverage is in place when the transaction closes.

In AFH v. Marsh, the harm was further compounded by the lengthy, atypical six year policy period. If the policy were renewed annually, which is typical, the mistake may have been caught during renewal and AFH may have at least been added to next year's policy. Because the D&O insurance was not considered when the restructuring took place an unknown coverage gap existed for five and a half years.

Do Not Be Lulled by "Inside" Transactions.

The parties in the AFH v. Marsh lawsuit were probably not thinking about change-in-control issues because the merger was an "inside" transaction where the new, surviving LLC, AFH, had identical assets and members as the old LLC. However, change-in-control provisions do not distinguish between arm's length mergers between two publically traded companies, for example, and mergers between closely held sister companies with the same owners and identical assets. Instead, change-in-control provisions can and do apply to all forms of transactions, whether those transactions are between Fortune 500 companies or family owned businesses, including asset and stock acquisitions, parent and subsidiary mergers and acquisitions, acquisition or mergers between sister companies, and changes in majority ownership or voting control.

Take the Simple Steps.

Gaps in coverage can be easily avoided by making sure that insurance issues are on the deal lawyers' due diligence "checklist." Coverage counsel can work with deal lawyers to ascertain whether the transaction will trigger change-in-control provisions and recommend the necessary steps to ensure seamless insurance coverage after closing. This involves reviewing the change-in-control provision, ensuring that the insurance carriers are notified of triggering events, and making sure that the merged entity is insured under the existing policies or that new policies are in place on the closing date for the surviving entity.

Notice! Notice! Notice to the Insurer of a Claim!

The AFH v. Marsh lawsuit also serves as a useful reminder to provide prompt notice of a claim to the insurer when it is first asserted against the company. In that case, AFH waited two years – until after the arbitration – to put its insurer on notice and request coverage. If AFH had the typical one year policy period that most companies have, the insurer would have denied the claim on late notice grounds. In addition to putting coverage at risk, a delay in giving notice results in the insured paying defense costs out of its pocket that the insurer should be paying. Moreover, when the insurer receives notice, it likely will deny responsibility for all "pre-tender" defense costs because it did not consent to those costs as they were incurred.

Deal lawyers cannot assume that a transaction, big or small, will not implicate insurance issues. Instead, they need to be cognizant of change-in-control provisions in insurance policies to ensure that their transaction does not create an unintended gap in insurance coverage and an unwelcome surprise to the client when it is sued. By engaging coverage counsel at the outset of a deal, the deal team can capably and thoroughly evaluate whether the transaction will trigger a change-in-control and take the necessary steps to notify the carrier and secure seamless insurance coverage when the deal closes.

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