Mergers & Acquisitions: Manage the Hidden Risks

It is a trend today for mergers and acquisitions to have more condensed timelines than they used to, which can lead to less time for performing a due diligence review. A rushed due diligence process increases the number of risks that could slide under the buyer's radar when reviewing a seller's past and current liabilities.

The reason hidden liabilities are such an issue is that the buyer's insurance typically doesn't cover them. Usually, when a company is acquired, its liability coverages are terminated or turned into run-off coverage, which expires after a set period of time, depending how the policy language is written. If these potential liabilities aren't considered when the purchase price is decided and the contract drawn up, the buyer could find itself questioning the transaction down the road—when it is too late to take any corrective action.

Taking on Liability

During a merger or acquisition, the buyer takes on the liabilities of the acquired company. The extent to which liabilities are taken on is determined by the type of sale. If the sale is an asset sale, the seller retains possession of the legal entity and its liabilities. Only the seller's individual assets and their accompanying liabilities are transferred to the buyer. Assets could include items like equipment, trade secrets, inventory or licenses. Buyers typically prefer these types of purchases, as they reduce the likelihood of future contract disputes, product warranty issues or product liability claims.

In a stock sale, the buyer purchases the selling shareholders' stock directly, and therefore obtains ownership of the seller's complete legal entity and all of its accompanying liabilities. Stock sales present more risk for buyers, who need to prepare for the possibility of future lawsuits, environmental concerns, employee issues or OH&S violations. These liabilities can be reduced to some extent through insurance policies and indemnifications. Still, performing thorough due diligence in a stock sale is crucial.

> Mergers and acquisitions have more condensed timelines than they had before—this increases the number of risks that could slide under the radar when a buyer is reviewing a company's past and current liabilities.

Consider the following examples of hidden liability:

- A selling company purchased several other organizations in the past few years, all of which the buyer must now track down, whether they still exist or not, in order to identify all their associated liabilities.
- A selling company has legacy exposures, which are ongoing legal claims that arose against the

This Risk Insights is not intended to be exhaustive nor should any discussion or opinions be construed as legal advice. Readers should contact legal counsel or an insurance professional for appropriate advice.
© 2014 Zywave, Inc. All rights reserved.

acquired company many years ago. The buyer must research the past cases and determine possible financial implications as well as their impact on its reputation and the possibility that similar cases could arise in the future.

Organizing and Updating Existing Insurance Policies

Depending on the circumstances, it may be wise for the buyer to combine the seller's existing insurance policies with its own. For example, the seller might have its fleet insurance structured one way, and the buyer might have its fleet insurance structured differently. Multiplying policy discrepancies across various lines of insurance and keeping track of policy limits, exclusions and deductibles becomes challenging. The buyer might find it more convenient, and more cost effective, to insure all the risks for both companies together. In addition to convenience, consolidation of policies will give the buyer an opportunity to reassess insurance policies to make sure the seller's limits were set at an appropriate value and deductibles are well-suited for the needs of the merged entity. A knowledgeable insurance broker is an invaluable asset during a merger or acquisition.

Environmental Risks

Every year businesses are faced with stricter environmental guidelines, meaning more environmental liabilities exist. Some types of environmental liabilities the acquired company could face in the future are pollution, mold and hazardous materials in air, in water or on land. It's important to pinpoint early any exposures for the company being acquired. Here are some ways to manage environmental risks:

- **Environmental impairment liability insurance** covers any vulnerabilities due to the void in general liability policies for pollution coverage.
- **Risk remediation cost containment insurance** can cover any cost overruns that weren't expected during pollution cleanup.
- **Premises pollution liability insurance** covers the costs of both off-site and on-site cleanup and remediation, as well as third-party lawsuits brought on because of hazardous material exposure.

D&O Risks

Directors and officers (D&O) policies are typically structured as "claims made." This means the insurance does not cover the company after the policy expires. If a claim is filed against the seller after the seller's D&O policy expiration date, the seller will then be responsible for paying any charges in full. Depending on specific contract details, this could mean that the buyer is responsible for footing the bill since it now has those responsibilities.

D&O policies are written with term limits, but claims may be brought up in the future, after the term limit has passed. To combat this risk, the seller will often purchase a noncancelable, pre-paid policy for a specified period, which is called run-off or tail D&O coverage.

Buyers will also want to consider that the directors and officers of the company being acquired—who may be slated to become executives of the acquiring company—will need to be added to the buyer's D&O policy. The policy of the company that was acquired will provide coverage only for actions that transpired when those directors and officers were executives of the acquired company, before the merger or acquisition; new coverage is needed for any future actions that occur.

Additional Coverages to Consider

In addition to updating existing coverage, many buyers purchase legacy liability policies, also called tail liability coverage, which cover the risk of future claims from the seller's discontinued products. Buyers also often purchase representations and warranties insurance to address any seller misrepresentations (intentional or not) that would impact the accuracy of the purchase price.

Manage the Hidden Risks

Asking the Right Questions

Asking questions, even when they are complicated or uncomfortable, and clearing up any confusion helps a buyer reduce risks and determine an accurate purchase price. Here are some questions that are not always asked, but should be:

1. Are there legal and financial risks attached to this merger/acquisition, and if so, what are they?
2. Do the acquired company's insurance policies have term limits that can sustain future financial liabilities, and any others that might pop up from past activity, before the transaction occurs?
3. Does the acquired company face any environmental liabilities at present time, and if so, what are they?
4. Is the acquired company in need of environmental cleanup in the future? How often?
5. What are the specific terms and conditions in the D&O policy of the acquired company?
6. Does the D&O policy have any statute-of-limitation clauses?
7. Does the company's post-transaction risk summary look different from how it did prior to the purchase?

Managing the hidden risks during a merger or acquisition may seem like a daunting task, but with the right information and support it can be done smoothly and thoroughly. Talk to HRO Resources for further insight into your potential risks and the measures that would best protect your company.