Insurance and Due Diligence in the Business Transaction

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On the heels of a major economic downturn, we are finally starting to see an uptick in the number of transactions, including the buying and selling of businesses, divisions, subsidiaries and product lines. Much of this activity is value driven, motivated by the **belief that with new management or capital, an under-performing business can turn the corner.** But with this activity comes a series of very important questions. What are the risks facing the parties to the transaction? How are those risks being allocated? And how are the parties protecting themselves from those risks? It is during the due-diligence process that these questions must be addressed. How they are answered is even more important in a value-driven transaction because there may be unique risks reflected in the "value" of the target.

The Primary Elements of Risk Allocation and Protection

Typically, parties utilize four primary devices to allocate and protect themselves from risks: **due diligence, representations and warranties, indemnifications, and insurance.** Due diligence is analogous to discovery in litigation; the parties seek to learn as much as possible about the subject of the transaction, and each other. They attempt to identify the known risks and liabilities, including past loss history, associated with the target business. They also attempt to uncover areas of potential risk, liability or concern associated with the proposed transaction.

Armed with the information they obtain in the due-diligence process, they then attempt to allocate responsibility for those known and potential risks. Usually this allocation takes the form of one party making representations and warranties about its knowledge of certain risks, and agreeing to indemnify, defend and "hold harmless" the other party in the event certain perils occur. A promise to provide indemnification is only as good as the financial ability of the party making the promise to back it up. A buyer may require that some amount of the purchase price be held in escrow, but in some situations setting an adequate escrow amount or duration may create an obstacle to completing a transaction. Ultimately, as a way of "backstopping" the representations, warranties and indemnities, the parties may purchase insurance. Some of that insurance may "go with" the subject of the transaction, while some may be purchased on account of the transaction.

Typical Concerns in the Due-Diligence Process

Primarily, the risk and insurance aspects of due diligence begin with an understanding of the structure of the proposed transaction. Questions likely to be asked include the following:

- Does the transaction involve a change in corporate structure, such as going from publicly held to privately held, or vice versa?
- Which liabilities will be transferred to the buyer and which will be retained by the seller?
- How will the acquired structure be incorporated into the acquiring entity?
- Is the transaction a purchase of stock, or is it a merger?
- How do the parties contemplate the disposition of insurance assets?
- Will any insurance policies be assigned to the buyer or anyone else? If so, are there any conditions that must be satisfied to make the assignment effective?

Once there is a clear understanding of the nature of the transaction and how the risks and insurance assets are to be allocated, the next level of inquiry concerns these and other more specific risks:

- Is there potential for long-tail or legacy environmental exposure? If so, how far back does the seller keep insurance policies?
- Is there potential that disappointed or dissenting stakeholders may bring claims?
- Will there be terminations or other restructuring of the workforce?
- Will there be deal-related obligations going forward, such as indemnification of the directors of the acquired company or indemnification by a former owner for older claims?
- Does the target entity have any known exposures of unknown magnitude, such as a tax dispute, a patent dispute or ongoing environmental remediation?

Once these issues are identified, the next step is to examine whether there is insurance in place for any of these risks. If so, the parties should determine in advance who can benefit from those policies. If the benefits cannot be assigned to the acquirer, then it is imperative to determine whether insurance can be purchased to protect the acquirer. In many cases, the answer is yes. Indeed, insurance policies that are potentially available and designed to address the examples above include environmental representations and warranties or "runoff" insurance; directors and officers liability (D&O) insurance; employment practices liability and fiduciary liability insurance; tax liability insurance; and patent infringement insurance. Any of these may be a more cost-effective alternative to putting large sums of money in escrow.

The Due-Diligence Checklist

The number of items that could be examined during the due-diligence process is nearly limitless, which is why a solid understanding of the transaction is so essential. That said, some of the broader categories of documents that should be obtained for the risk and insurance portion of the due-diligence process, depending on the type of transaction, likely will include:

- Copies of all insurance policies going as far back in time as possible
- Copies of anything that would establish that the target company is an "additional insured" on another party's insurance policies
- Evidence that other companies are "additional insureds" on the target's insurance policies
- Reports of insurance and risk-management consultants
- Insurance loss runs going back at least five years
- Notices and claims correspondence with any insurer with respect to any open claim or potential claim
- Documents relating to any insurance-coverage litigation or dispute involving the target, including judgments, settlements and documentation reflecting whether any "legacy"

coverage has been impaired or exhausted as a result of the payment of claims or settlements
- Details of the target's significant historical events, such as former corporate parents, acquisitions and dispositions, opening and closing of domestic and foreign locations, names changes, and significant management decisions or changes
- Litigation files, particularly those where insurance may play or have played a role
- Documents relating to the target's material contingent liabilities, including notices to insurers regarding them.
- Leases and licenses

If effective, the due-diligence process will provide all parties with the knowledge they need to assess and allocate risk, and reduce the likelihood that a peril will occur that has not been accounted for and insured against. If you are contemplating a significant corporate transaction, talk to your attorney about the benefits of making sure that the due-diligence process includes a rigorous risk and insurance analysis.

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