OPINION

Insurance and risk in M&A transactions

The checklist is long, but with meticulous attention to detail, a firm can avoid unpleasant surprises after closing the deal.

Dan
Knise

GUEST SPEAKER

Merger and acquisition activity among A/E firms continues to heat up. When planning to buy, sell, or merge with another firm, you need to understand and evaluate various risk and insurance issues that can affect the success or terms of the transaction.

Two of the most important steps are to:

- Start early and make sure that risk management and insurance issues are being addressed throughout the process
- Gather all the necessary information to allow a complete understanding of the issues and opportunities

With regard to gathering information, we usually suggest asking the entity being acquired to provide the following:

- Summary of insurance policies carried for each of the last three years (often called a schedule of insurance)
- Copies of all current insurance policies
- Insurer loss runs or claims history for at least the last three years
- Details of any open claims or circumstances that might give rise to a claim
- Summary of risk management policies and procedures

Be sure the information provided includes not only professional liability policies, but also all property/casualty and management liability insurance policies.

CLAIMS INFORMATION CAN PROVIDE VALUABLE CLUES. Claim information, in particular, can be a critical indicator of future problems or management issues that you will want to factor into your acquisition terms and conditions. For larger firms, you'll want to go back further than three years and obtain loss runs for five or even 10 years. The focus should be on any open professional liability, general and auto liability, property and other claims. Review all large claims and flag any circumstances that could turn into claims.

"Start early and make sure that risk management and insurance issues are being addressed throughout the process."

The claims-made nature of professional liability insurance policies heightens the need to understand any potential circumstances and the to-be-acquired firm's risk management practices. Under a claims-made insurance policy, even errors that occurred years ago are paid by the insurance policy in effect at the time the claim is filed. Making this even more of an issue is that unlike general liability policies, PLI policies have an overall aggregate limit, which includes all claims expenses (including defense costs).

See DAN KNISE, page 4

DAN KNISE, from page 3

EXTENDED REPORTING PERIODS CAN ASSIST. One solution often utilized is for the selling firm to purchase an extended reporting period, or "tail" coverage, as an extension to its last claims-made policy. Most ERPs extend for one, two, or three years. While the insurance limit usually remains the same, it applies for the entire ERP period versus a single year when a PLI policy is typically renewed. This restricts the monies available to pay claims and could increase the risk of uncovered claims.

To help determine an appropriate duration for tail coverage, some firms check the statutes of limitation and statutes of repose in states where they have current or completed projects. Statutes of limitation define the maximum timeframe after an event or accident that legal proceedings may be initiated. They vary by jurisdiction and may, under certain circumstances, be extended.

Statutes of repose specify the maximum time after completing an act, such as completion of a construction project, that legal proceedings can be initiated. Some state statutes provide more than 10 years of liability.

"When planning to buy, sell, or merge with another firm, you need to understand and evaluate various risk and insurance issues that can affect the success or terms of the transaction."

Unfortunately, most ERPs will not extend for such longer periods and buyers and sellers will have to evaluate other options including whether or not the seller's liabilities can be rolled into the buyer's PLI policy.

OTHER CLAIMS-MADE POLICIES NEED ATTENTION TOO. Speaking of claims-made policies, it is important to keep in mind that there may be other claims-made policies beyond PLI that require tail coverage. These include directors and officers liability, employment practices liability, fiduciary liability, and employee benefits liability (under the commercial general liability policy).

During a merger or acquisition, EPLI coverage can be critical; eliminating staffing redundancies may require terminating employees, which can lead to employment-related claims. Be sure to understand your policy's coverage, tail and claim reporting provisions and requirements.

CHECK WORKERS' COMPENSATION. Sellers with elevated accident or injury rates can have profoundly negative effects on an acquiring firm's business. Workers' compensation insurers use a rating system based on an employer's loss history to set that entity's insurance premiums.

Significantly, the rating, known as an experience modifier, is among criteria project owners and managers use to evaluate design and construction firms working or bidding on their projects. A poor rating can disqualify a firm from a bid or retaining a client. So, be sure to assess whether and how the seller's workers' compensation loss experience might affect your business.

KEY CONSIDERATIONS IN OTHER COVERAGES. With regard to commercial general liability and other related property/casualty insurance policies, it's common to add the acquired firm to the acquirer's CGL and other policies as an "additional named insured." In a merger, the combined entity should have both predecessor companies as named insureds in its CGL policy to address any current occurrences arising out of the combined operations.

For property and other insurance policies, be sure to have a process in place to identify coverages carried by each firm, ensure continuity of needed coverage, and cancel redundant policies.

INSURANCE AND PRICING. In pricing M&A transactions, many buyers employ a two-year earn-out or escrow fund to address contingencies arising post-closing. This fund should also contemplate insurance-related costs, such as those for audits related to workers' compensation, general liability, and automobile liability policies, as well as for deductibles and self-insured retentions, which can be $25,000 to $500,000 or more per claim under some policies.

Successful mergers and acquisitions require careful due diligence, which should include risk and insurance issues. Be sure to reach out to your insurance broker and tap their experience and expertise with merger-related insurance and risk management issues.

DAN KNISE is president and CEO of **Ames & Gough**. Contact him at dknise@amesgough.com.