AmWINS Group, Inc.

CLIENT ADVISORY

Essential Considerations When Buying D&O Run-Off Coverage

Corporate acquisition activity is beginning to increase significantly. As of early April 2011, the aggregate value of corporate acquisitions on a year-to-date basis, $943.3 billion, was at its highest since 2007 according to global M&A tracking firm Dealogic. Thus, chances are increasing that one or more of your corporate clients may be involved in a takeover in the coming year.

There are a lot of factors to consider, from an insurance perspective, when a corporate acquisition occurs. In this article we'll examine some of the important factors impacting the purchase of D&O run-off coverage. In future installments, starting next month, we'll examine other merger-related insurance topics.

What Exactly is D&O Run-Off Coverage?

Before we turn our attention to D&O run-off coverage, let's be clear as to exactly what it is.

The vast majority of D&O policies (with exceptions so rare as to not be worth mentioning) are written on a "Claims Made and Reported" basis. This means that coverage only applies to claims that are *first made against the insureds and reported to the insurance carrier* during the policy period. Once the policy expires, the insurer will not accept any additional claims.

Thus, run-off coverage (sometimes referred to as tail coverage or an extended reporting period) was created to continue protecting directors and officers from lawsuits arising from acts committed before their D&O policy's ongoing coverage expired but not filed until after the policy's expiration date. This is a common scenario with acquisitions: Once the ongoing D&O coverage is terminated on the date of acquisition (or, sometimes, just a major sale of assets or other change in control) directors and officers of the selling entity still want coverage from any future lawsuits which may arise from their past actions.

Two items to note: 1) For clients who don't have D&O prior to the acquisition, it is not too late. There are few insurers willing to write a run-off policy for an organization that never previously purchased the insurance. Many insurers are afraid of the scenario where they take on prior liabilities and only collect one premium. With the proper market relationships you should be able to find a solution. 2) Nearly every D&O policy has an automatic conversion to run-off provision. That provision will state that if there is a change of control (greater than 50% of assets or 50% of voting stock changes hands), coverage for ongoing acts will terminate, but claims arising from prior acts will be covered until the policy's natural expiration.

Unless the acquiring company agrees to assume 100% of all liabilities of the acquired company's board of directors – a rarity – the acquired company will most likely want to purchase D&O run-off coverage. Even where the acquiring company makes such an offer, the board of the target company may nonetheless insist upon being responsible for buying its own D&O run-off coverage from an insurance carrier. This way, the target company doesn't have to worry about such things as: 1) The acquiring company going insolvent and not being able to fund the costs of future claims; 2) Management changes at the acquiring company that may cause new management to repudiate previous promises to protect the target company's board; or 3) Indemnification by the acquiring company that is more restrictive than the terms of the expired D&O policy.

Essential Considerations When Negotiating D&O Run-Off Coverage for Your Clients

1. Terms and Conditions: Generally, it is best if the D&O run-off coverage is as broad as possible. Keep in mind, there's no magic rule that says that clients have to buy *exactly the same coverage* that was in the D&O policy in effect at the time of the acquisition. Try to negotiate with the incumbent carrier for broader coverage than the expiring, or buy the D&O run-off from a completely different carrier, even one who never previously had a relationship with your client.

Carriers generally consider D&O run-off coverage to be very profitable premium because, the logic goes, most plaintiffs with a potential claim of any significance will file it as soon as they hear that the defendant is being acquired. People who feel that they are justifiably owed a lot of money seldom wait a long time to file their claims. Thus, while run-off coverage provides important peace of mind to outgoing directors and officers, it's not called upon to pay claims as frequently as on-going D&O coverage.

Some D&O policies contain pre-negotiated run-off provisions that purport to dictate pricing and terms in advance of an acquisition. Usually, these will contain a cap on pricing (e.g. "Three-year run-off will be no more than 250% of the expiring one-year premium") and would have the insured just continue with the same expiring coverage terms and conditions for the run-off period (or extended reporting period) with

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If you do not have a financial services contact at AmWINS, click here for a list of brokers on our website.

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no enhancements. Again, there is no obligation to accept this, and you can easily shop around for more competitive quotes with broader terms. The current insurer may also be willing to expand coverage rather than risk losing the run-off premium to another insurer.

2. Pricing: Run-off pricing will fluctuate with market conditions, but generally a one-year run-off policy should cost no more than 90% of your expiring premium (because, remember, there's no coverage for ongoing acts in it), three-year run-off should be between 125% and 250% of the expiring one-year price, and six-year run-off may go from 200% to 300% of the expiring. Some acquisition agreements will specifically state how much the target company may pay for its D&O run-off, and may even specify for how long it should remain in force. It's important before the acquisition deal is finalized to make sure that such dictates are realistic under today's market conditions.

3. Policy Period: The majority of run-off claims are made against insureds within the first year after the acquisition occurs. However, because statutes of limitations are longer for many types of wrongdoing (for example, plaintiffs have up to five years to file fraud claims under Sarbanes-Oxley), outgoing directors and officers usually want "sleep insurance" that affords them protection for at least three years, and frequently six. Carriers typically try to price the six-year option very attractively when compared with the three-year option because they know that the likelihood of a D&O run-off claim being filed in years four, five and six after an acquisition is slim, and, thus, they're eager to attract the additional premium.

4. Limits: Where the run-off coverage option is built into an expiring D&O policy's terms and conditions, the carrier usually attempts to tie the run-off limit into the available limit remaining on the expiring policy. Thus, if your client had a $10 million D&O limit on the policy in force during an acquisition but $2 million of that was already used to pay a claim, then the carrier would try to maintain the run-off policy's limit of liability at $8 million – the amount that was still available under the policy in force during the acquisition. There's no reason that the insured has to accept this. If the incumbent carrier won't offer fresh limits – and maybe your client will even want more limits than were expiring – then it's time to shop around to see what other carriers might be willing to offer.

It's important to remember that if a board of directors felt it needed $10 million per year in protection for D&O claims that might arise before the acquisition, they will now be stretching a single limit over as many as six years. Granted, there will be no liability under the D&O run-off policy arising from on-going acts after the acquisition, but the board may still want increased limits over their original $10 million given how long the policy will be in effect. This is certainly an issue that should be raised with the client.

5. Carrier's Financial Strength: Given that the D&O run-off policy will be in effect for up to six years, it's wise to choose a carrier who is financially strong and will likely be around to pay claims years down the road (for example, a claim filed in year five may not be paid until ten or more years after the acquisition closed.) This may necessitate buying the run-off from a company other than the incumbent carrier. It's certainly a viable option which must be considered. Another solution to consider is to add what is called a Side A DIC policy that would have the ability to drop down and fill a gap in the program created by the insolvency of one of the insurers. The coverage would only apply to the insured persons, but after all, we are talking about properly covering Directors and Officers with this product.

6. Laundry-Listing the Incumbent Carrier: D&O policies usually contain a provision allowing insureds to notify the insurer of a potential claim. Later, if an actual claim is filed based upon the specific facts and circumstances which were reported, that claim will deem to have arisen under the policy in force when the Notice of Potential Claim was accepted by the carrier. Be aware, however, that carriers will require a lot of specifics about a situation in order for it to qualify as a Notice of Potential Claim. Merely stating, "Our stock price went down and we're nervous that we might get sued," probably won't work. The carrier would most likely reject such a notice and advise that you'll need more specifics to make it a valid Notice of Potential Claim.

When a policy is about to expire without being renewed, many insureds will "laundry list" carriers, meaning that they provide the carriers with as many potential claims as can be discovered internally. This way the insured would get coverage for those matters – should they blossom into actual claims – from the expired policy's limits of liability while protecting the new policy's limits for future, unknown claims.

Insureds who are buying D&O run-off coverage from a carrier other than their incumbent will frequently laundry list the incumbent carrier in order to protect the new limits. In fact, sometimes the new carrier will even go so far as to review the laundry list and help the insured word it properly so as to maximize the chances of it being accepted by the incumbent carrier. Conversely, if the incumbent carrier is providing fresh limits for a D&O run-off policy, it will usually require the insured's agreement that no laundry list be given to it under the old policy. This is a very important consideration when deciding to move D&O run-off coverage to a new carrier.

Run-off D&O coverage, as is typical in the professional lines field, is a complex proposition that needs to be individually tailored to the needs of the client under its specific circumstances. While the points addressed above are critical considerations in any run-off placement, no single article can address all potential considerations exhaustively for every unique situation.

If you should find yourself in need of advice regarding D&O run-off for a client, or need help with any other aspect of the complexities of professional lines insurance, you should always feel free to consult with one of the experts at AmWINS; they'll be happy to help you achieve a successful placement.

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