COVERAGE INSIGHTS

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D&O Insurance Coverage Gaps in M&A Transactions

Mergers and acquisitions (M&As) create a distinct period of directors and officers liability (D&O) risk that doesn't exist during normal business operations. Directors and officers make decisions that can significantly affect shareholders and other stakeholders, making M&A transactions a common source of litigation.

In public company transactions, shareholder lawsuits frequently follow a deal announcement, with allegations often involving inadequate consideration, incomplete disclosures, conflicts of interest or flaws in the sale process. Private company transactions typically generate fewer lawsuits, but disputes can still arise over valuation concerns, fiduciary duties or what the board disclosed during negotiations.

D&O insurance responds differently during the M&A period than it does during ordinary operations. Several policy provisions can affect whether claims are covered, making it important for buyers, sellers and their executives to understand how coverage works before a transaction closes.

The Bump-up Provision

Many public company D&O policies, and some private company policies, contain a bump-up provision. This language may exclude the portion of a settlement or judgment that represents an increase in the consideration paid for an acquired company. For example, if shareholders allege that the company was sold for too little and a settlement effectively increases what they receive, the insurer may argue that the additional amount isn't covered.

Many forms preserve coverage for defense costs and nonindemnifiable losses involving individual directors and officers, but the scope of those carve-backs depends on policy wording.

Bump-up provisions are particularly relevant in public company litigation involving allegedly inadequate consideration. They may also apply to private company transactions, depending on the allegations, the M&A structure and policy language.

Exact wording varies by insurer. Some provisions apply when the insured company is the buyer, while others focus on M&A transactions in which it is the target. Courts have also interpreted bump-up provisions differently. Buyers and sellers should review their specific policies rather than assume how broadly the provision applies.

The Conduct Exclusion

Deal-related lawsuits often allege that directors or officers made misleading disclosures, acted in their own interests or otherwise breached their fiduciary duties during the M&A period. These claims may implicate a policy's conduct exclusion.

Many D&O policies require a final, nonappealable adjudication before a conduct exclusion applies, although some forms use a different trigger, such as a written admission. Until the required trigger is met, insurers generally continue advancing defense costs, subject to the policy's terms and conditions.

That distinction matters because many M&A lawsuits settle before a court makes a final determination regarding fraud or other intentional misconduct. As a result, the conduct exclusion often doesn't ultimately eliminate coverage, even though it may be raised during a claim.

Prior Litigation and Known Circumstances

Before closing, buyers should review the target company's D&O policy for provisions addressing prior or pending litigation, prior notice and known circumstances. These provisions help determine whether claims related to events that occurred before the M&A transaction will be covered.

Coverage may be limited or unavailable if a claim relates to litigation that was already pending before the policy's applicable date, circumstances previously reported to another insurer or facts the company knew about before the policy was issued but didn't disclose during underwriting. Understanding how these provisions apply before closing can help avoid unexpected coverage disputes if a claim arises after the transaction.

Both parties should also understand which policy will respond if a claim is first made after closing but involves conduct that occurred before the transaction.

The Run-off Gap

Once an M&A transaction closes, the target company's D&O policy generally covers only claims arising from pre-closing conduct. Without tail coverage, claims arising from that conduct may no longer be covered if they're first made after the policy's reporting period ends.

Tail coverage extends the period during which claims involving pre-closing conduct can be reported, helping close this potential coverage gap. Because the opportunity to purchase tail coverage may be limited, it generally should be arranged before closing. M&A agreements commonly specify which party is responsible for purchasing the tail and may cap the amount that must be spent. Those terms should be negotiated during the transaction rather than addressed after the deal is complete.

What to Confirm Before Closing

Coverage review should be part of the M&A transaction's due diligence process, not an afterthought. Before closing, buyers and sellers should confirm that:

- Tail coverage has been arranged, and the M&A agreement specifies which party is responsible for purchasing it.
- Prior or pending litigation, prior notice and known circumstances provisions have been reviewed.
- The policy's bump-up provision and conduct exclusion have been evaluated in light of the transaction structure.
- The policy's change-in-control provisions have been reviewed so both parties understand how coverage will operate after closing.

Key Takeaways

D&O insurance doesn't automatically protect every claim arising from an M&A transaction. Understanding how these policy provisions work before the transaction closes can help buyers, sellers and their executives identify potential coverage gaps and address them before the process is complete.

Contact us today for additional insurance guidance and solutions.