

Insuring Against Successor Liability With Contingent Liability Insurance

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In today's challenging economic landscape, closing an M&A transaction can prove particularly difficult. Buyers have become extremely risk averse and methodical in their approach to deals, while sellers are frequently motivated by urgent liquidity needs, resulting in the need to get a deal done quickly. Add to the mix a target company faced with a potentially material contingent liability, such as pending litigation or a potential tax exposure, and closing an M&A deal can become near impossible.

Where possible, the risk averse buyer will try to structure a deal as an asset purchase transaction (rather than a merger or stock purchase) in an attempt to specifically exclude the contingent liabilities post-closing. In the event an asset sale is not feasible, the buyer will look for other ways to protect itself from these liabilities, such as receiving a specific indemnity from the seller, putting in place an escrow to respond to the specific issue, negotiating a purchase price adjustment, etc. Despite these deal structuring maneuvers, buyers cannot completely shield themselves from such contingent liabilities. Even in the context of an asset sale, a court may still treat the buyer as the target's legal successor and, accordingly, the party ultimately responsible for the pre-closing contingent liabilities. Thus, absent another solution, buyers are essentially faced with the unpleasant decision of either scuttling the transaction or assuming the successor liability risk.

The M&A insurance products provided by Chartis can provide a valuable solution for buyers faced with this conundrum. Contingent Liability Insurance ("CLI") can be used to eliminate or reduce contingent liability exposures relating to the business of a seller or otherwise arising in connection with M&A transactions, such as successor liability exposure.

In basic terms, successor liability is a creature of federal, state and common law and is an exception to the general rule that, when one corporation sells substantially all of its assets to another corporation, the purchaser is not liable for the seller's debts or liabilities. However, this general rule has roughly six categories of exceptions that are not uniformly adopted across the United States, and require a careful review on a jurisdictional basis that is beyond the scope of this article. These categories of exceptions generally include: (1) where the buyer expressly or impliedly agrees to assume the target's liabilities; (2) where the transaction is really a de facto merger (e.g., continuity of shareholders, management, personnel, physical location of the assets and business operations); (3) the new business is a "mere continuation" of the target's business (e.g., similar to a de facto merger except the focus is on the continuity of the officers, directors and shareholders); (4)

where the transaction was fraudulently engineered in order to escape liability; (5) where the buyer acquires and continues a manufacturing business (this is often referred to as the “product-line exception” and is intended to hold the purchaser responsible for defective products, and products that lack adequate warnings); and (6) statutory imposed liabilities (e.g., environmental claims under CERCLA, pension and employee claims under ERISA, Title IV, National Labor Relations Act, and certain state and federal tax laws).

A recent example of how Chartis’ CLI product enabled a risk averse buyer to consummate a transaction despite significant potential successor liability exposure illustrates this product’s utility in facilitating M&A deals. In this example, Chartis was approached by a buyer that was considering the purchase of substantially all of the assets of a target company for approximately \$14 million. However, the buyer was unwilling to consummate the asset purchase transaction because the target was a primary defendant in a potential multimillion dollar class action toxic tort lawsuit. Essentially, the buyer was concerned that should it consummate the asset purchase transaction and the target failed to satisfy all or some portion of an adverse judgment in the litigation after the closing, then some theory of successor liability could be applied with the result that the buyer would be deemed legally responsible for any unsatisfied amount as the target’s legal successor.

Chartis’ solution was to structure a CLI policy that provided the buyer with \$3 million of protection. Specifically, the policy covered defense costs incurred by the buyer in defending its position that it was not the legal successor of the seller, as well as amounts for any settlement or final judgment. The buyer incorporated Chartis’ CLI policy as a closing condition to the asset purchase transaction, which successfully closed with the insurance in hand.

As this example illustrates, CLI can be a valuable tool for parties engaged in an M&A transaction where contingent liabilities, such as successor liability concerns are preventing or hindering a deal from going forward. These products can allow both buyers and sellers to gain the protection that they need in order to feel comfortable closing a transaction.

