

Director Liability Loss
Prevention in Mergers and
Acquisitions

CHUBB®

Director Liability Loss Prevention in Mergers and Acquisitions

Prepared by Dan A. Bailey
Bailey Cavaliere LLC
For Chubb

Contents

Foreword	4
Introduction	5
Legal Standards	6
Develop Long Term Strategy	9
Informed Decision	10
Reliance on Experts	12
Disinterested Outside Directors	13
Special-Committee Activities	14
Seek Best Value	15
Disclosures	17
Going Private Transactions	19
Business Operations	20
Anticipate Litigation	21
Financial Protection	22
Indemnification	22
Insurance	23
Conclusion	25
About the Author	26

Foreword

The directors of a company considering a proposed takeover must carefully determine whether an acquisition of the company and the terms of the acquisition are in the best interests of the company and its shareholders and, if so, how to move forward with it. Even under the best of circumstances, that will likely require far more time and effort from the directors than they expected. Unfortunately, directors are routinely rewarded for this huge commitment by being sued. Shareholders typically allege the directors acted improperly in investigating, negotiating, approving, rejecting, or disclosing the acquisition transaction, regardless of how thoroughly and prudently the directors acted. Even though no amount of planning or diligence will prevent the filing of lawsuits, directors can increase the defensibility of those lawsuits and improve the quality of their decision-making process with respect to a proposed acquisition by anticipating and implementing various loss prevention practices.

As one of the world's leading writers of directors and officers (D&O) liability insurance, Chubb believes the best executive liability risk management strategy combines several techniques, including quality D&O liability insurance, sound corporate governance practices, and expert legal assistance. Chubb asked Dan A. Bailey, Esq., a nationally recognized authority on D&O issues, to prepare this exclusive directors' liability loss prevention booklet aimed at helping directors maneuver through the treacherous issues surrounding a merger or acquisition (M&A) transaction. In the pages that follow, he reviews the basic legal duties of directors in this context and summarizes many loss control procedures for directors when addressing a proposed M&A transaction.

We at Chubb hope this brochure will help educate and guide directors even before an M&A transaction is proposed. It is our intent to help directors develop effective loss prevention strategies, but no booklet is a substitute for expert legal advice. We strongly encourage you to seek competent counsel for specific issues relating to M&A matters.

Introduction

When a company becomes the target of an actual or proposed M&A transaction, its directors are thrust into a highly volatile and risky claims environment. Any decision to approve or reject the transaction or to engage or not engage in a process will likely disappoint some constituents, who can—and very frequently do—sue the directors for alleged wrongdoing in connection with the transaction.

A combination of factors explains why directors of a target company are so vulnerable in this context. By definition, the transaction involves the very existence of the company and is one of the most important decisions a board must make. Significant amounts of money can be at stake, and shareholders, employees, customers, vendors, communities, and other constituents may be affected. These transactions typically move quickly, so directors must make important decisions in a very short time period and may not have as much information or deliberation as ideally preferred. Moreover, in many cases, directors of the target arguably may not be entirely disinterested in the outcome. Plaintiffs' lawyers often allege that, if a transaction occurs, the directors were motivated because they made an attractive gain on the company shares they owned or, conversely, if a transaction does not occur, that the directors were

motivated by wanting to keep their lucrative board seats. To further aggravate the situation, directors must deal with these challenges while being critically and closely watched by investors, the press, and—importantly—plaintiffs’ lawyers.

This booklet discusses various loss prevention concepts for directors of a target company when evaluating, negotiating, approving, rejecting, or disclosing a proposed M&A transaction. Although there is no standard blueprint for directors to follow when placed in this highly difficult situation and the directors stand a good chance of being sued by shareholders regardless of what they do, certain fundamental guideposts can reduce the liability exposure for those directors and can enhance the quality of the directors’ decisions involving the proposed transaction. Underlying all these loss prevention concepts, though, is the need for directors to obtain expert legal advice throughout the process.

Legal Standards

Legal standards vary by jurisdiction, but courts generally recognize some basic principles that define the standards of conduct for directors of the target company in a proposed or actual change-in-control transaction:

- The decision to sell a company is an affirmative decision of the board of directors, and no company should be “for sale” from a legal perspective until its board of directors makes that decision. However, once a company is “for sale,” outside, disinterested directors should control the investigation and response to the proposed transaction and should decide what, if any, role officers (including directors who are also officers) should have in that process.

- The directors should make a thorough, well-documented investigation before acting.
- If directors want to adopt defensive measures in response to an actual or potential takeover proposal (such as poison pill plans or staggered director elections), the directors should reasonably believe the takeover proposal is not in the best interest of the company and should adopt only measures that reasonably respond to the identified threat posed by the takeover proposal. Directors have broad authority under applicable state law to unilaterally adopt without shareholder approval various measures that can discourage, thwart, or otherwise affect a takeover proposal. These defensive measures frequently become the focus of litigation against the target's directors and are appropriate only if the defensive measure increases the bargaining position of the target's board or otherwise protects the interests of the company and its shareholders. Although the directors' adoption of takeover defenses can increase litigation risks for the directors, thoughtful and measured takeover defenses often help directors fulfill their fiduciary duties to shareholders, particularly if adopted prior to any specific takeover proposal.
- If the directors decide to sell the company or to seek an alternative transaction involving the breakup of the company, the directors should focus on obtaining the highest value for shareholders and, if necessary to accomplish that goal, should conduct an open and unrestrained bidding process.

Importantly, some courts have recognized that because there is the potential for directors to be conflicted when evaluating a proposed takeover, the duties of directors in a change-in-control situation are often heightened. However, even under a higher standard of care, courts generally give directors a great deal of latitude in reacting

to a takeover proposal. For example, many courts have ruled that if remaining independent is consistent with the company's long-term strategy, directors can "just say no" to even very rich takeover proposals without breaching their fiduciary duties.

Litigation involving an M&A transaction usually is filed by the target's shareholders against the target's directors because the directors have the responsibility to investigate, evaluate, and respond to a proposed takeover transaction. These lawsuits typically allege the directors breached their fiduciary duties to the shareholders and may also allege (among other things) that the directors violated federal securities laws by misrepresenting or omitting material information in the proxy materials relating to the shareholder vote on the transaction. Often, the lawsuits are settled by the directors' agreeing to amended disclosures in the proxy materials and perhaps revised procedures relating to the transaction, such as an extended period to solicit alternative bids, a reduced termination fee, the redemption of poison pill, amendments to other takeover defensive arrangements, or an extended appraisal rights period. In truly exceptional cases, these lawsuits can even result in the court's changing the price paid to shareholders or preventing the transaction from occurring.

Nonetheless, M&A lawsuits can pose a significant and growing financial risk for director defendants:

- A few settlements in such cases have recently grown to tens and even hundreds of millions of dollars;
- Even in a nonmonetary settlement, the defendants might become obligated to pay the plaintiffs' attorneys fees, which can reach into the millions of dollars;

- An expedited motion to enjoin the transaction before closing can be extremely expensive to defend because it can be like a full trial based on extensive factual discovery; and
- Plaintiffs' attorneys now frequently file similar suits in multiple jurisdictions, thereby increasing the directors' defense costs and creating the risk of inconsistent court rulings.

Develop Long-Term Strategy

Outside the context of a takeover proposal, directors should consider establishing a long-term business strategy for the company and a time frame for achieving corporate goals. This strategic planning responsibility is an important function of a board of directors. Importantly, developing and documenting the long-term strategic plan and considering various strategic alternatives in developing that plan can not only provide a valuable road map for the company but also serve as a valuable defense for directors who decide to reject a proposed takeover opportunity.

Courts generally recognize that directors have the authority to set a corporate course of action, including a time frame, designed to enhance corporate profitability. As a result, directors are not obligated to abandon a deliberately conceived corporate plan in order to maximize short-term shareholder profits through a takeover transaction.

To best rely on a long-term corporate strategy as a defense to a takeover proposal, the corporate strategy should be thoroughly considered, developed, and documented prior to a takeover transaction's being proposed. In addition, the strategic plan should be

relatively current and continue to reflect the company's business and competitive opportunities and risks. Directors are well-served by considering various strategic alternatives in determining the optimal strategic plans for a company. In other words, effective M&A loss prevention for directors best begins long before a takeover is proposed and evaluated. Maintaining an up-to-date strategic plan not only helps fulfill the directors' general oversight responsibilities but also can be invaluable when deciding how to respond to a takeover opportunity.

Informed Decision

When responding to a takeover proposal, directors should create a record demonstrating that they carefully and thoroughly considered relevant information regarding the proposed transaction and then made an informed decision. For example, it is helpful for directors to, among other things, (i) discuss at length the terms, merits, risks, and rewards relating to the proposed transaction and do so over numerous meetings, if possible; (ii) be directly involved in or closely oversee the evaluation and negotiation of the proposed transaction; (iii) receive and consider a formal opinion from a qualified investment banker regarding the fairness of the proposed terms; (iv) consider the company's current and long-term prospects regarding its business, operations, financial condition, and earnings as well as current and prospective general economic, market, and industry environments; (v) consider the proposed transaction terms relative to the current, historical, and prospective stock market price for the company and other peer companies; (vi) consider possible benefits from and detriments to the proposed transaction, including potential cost savings, business synergies,

changed regulatory oversight, and reduced disclosure obligations; and (vii) obtain legal and other professional advice relating to the consequences of different decisions by the directors, issues created by the transaction, the transaction documents, and compliance with the directors' fiduciary duties.

Directors of the target company should be particularly vigilant when evaluating a transaction that will be funded by stock rather than cash. In addition to thoroughly investigating and understanding the value of the target company, the directors should also investigate and understand the current and projected future value of the acquiring company's securities that the target's shareholders will receive in the transaction. Because the valuation of both companies is involved, negotiating an appropriate exchange ratio for a noncash transaction is fraught with extra challenges.

When evaluating a proposed takeover, directors should consider not only the potential value of the transaction to shareholders when compared with other alternative, reasonably available transactions or strategies but also the risks inherent in the transaction. For example, if a transaction is publicly announced but is delayed or not completed, the company may lose valuable employees and may jeopardize important relationships with customers, vendors, creditors, and other constituents. As the risks that a proposed transaction will not close increase, directors should be sensitive to the potential negative impact on the company if they recommend a transaction that does not close.

Directors should not only act prudently but also create a record of acting prudently. Minutes and other documents should confirm that the directors requested, received in advance of meetings, and considered a wide range

of information and devoted sufficient time to make an informed decision. Among other things, it is helpful for the record to reflect multiple and lengthy meetings by directors, advice from and dialogue with the financial advisor and other experts retained by the directors, questions and testing of expert opinions, and active involvement in or oversight of negotiations with a buyer.

Reliance on Experts

Takeover transactions typically raise various strategic, financial, and legal issues that are highly complex. As a result, directors should obtain advice from experienced, qualified, and independent experts in each of the relevant substantive areas. Independent directors are encouraged to be closely involved in selecting these advisors—and approve their compensation arrangements—to avoid a perceived taint on the independence of the advisors. Each advisor should have extensive, successful, and current experience in M&A transactions. Because cutting-edge practices, tactics, and legal principles rapidly change in this area, directors should be guided through the process by the experts.

It is important that the advisors be, both in fact and in appearance, disinterested with respect to the success or failure of the proposed transaction. Each advisor's compensation should be outcome neutral, and advisors should not have relationships with management or any of the proposed parties to the transaction that create issues. The record should clearly reflect that the advice received by directors from these advisors is given with a view toward the best interest of the company and its shareholders. Typically, current or former advisors, including legal counsel, for the company should be disqualified from providing advice to directors with

respect to a proposed takeover because those advisors may be perceived to have a loyalty to incumbent management or to have a bias against the takeover in order to preserve their business relationship with the company.

Disinterested Outside Directors

A proposed takeover transaction could present actual or perceived conflicts of interest for directors and officers who either may be impacted by the transaction or who may have relationships with one or more parties affected by the transaction. For example, plaintiffs' lawyers often argue that officers may lose their jobs because of the transaction and therefore may have a bias against the transaction. Conversely, in a going-private transaction or leveraged buyout by management, plaintiffs' lawyers often argue that certain directors and officers have a bias in favor of the transaction due to their increased ownership of the company as a result of the transaction and have a conflict of interest due to their desire to pay as little as possible in connection with the transaction. Directors and officers who have a bias or conflict of interest with respect to the transaction will likely lose the benefit of the Business Judgment Rule defense when they are sued.

To avoid these issues, only independent and disinterested outside directors should act on behalf of the company with respect to the proposed transaction. Typically, the board of directors should appoint a special committee composed only of independent and disinterested outside directors and should fully empower that committee to make all decisions and otherwise address all issues relevant to the proposed transaction on behalf of the board. Among other things, the board

should specifically delegate to the committee the board's full power to negotiate, seek strategic alternatives, and, if appropriate, deploy defensive mechanisms with respect to the proposed transaction.

When selecting members of a special committee, the board should consider not only the independence of the appointed directors but also their skills, experiences, energy level, and time availability. If possible, at least some of the directors serving on this special committee should have strong financial experience and prior involvement in one or more M&A transactions. In addition, if a special committee is formed, the board should consider monitoring and reevaluating the continuing independence of the committee members throughout the transaction. A record that reflects this periodic review can be helpful.

Special-Committee Activities

If a special committee of the board is necessary, it should be formed early in the transaction process and before the range of possible outcomes has been significantly narrowed. The committee should be involved in the entire evolution of the transaction. Good practices by a special-committee include the following:

1. The board resolution that appoints the special committee should describe the function and authority of the special committee in specific yet broad terms.
2. Any special compensation arrangement for the members of a special committee should be in writing and outcome-neutral.
3. If possible, only independent outside directors on the board should nominate and select members of a special committee.

4. A special committee should establish rules of confidentiality regarding information and deliberations relating to the proposed transaction, and those rules of confidentiality should be communicated in writing to advisors or other persons who deal with the committee.
5. Effective minutes of all meetings of a special committee should be maintained and ideally reflect frequent and substantive meetings, a thorough deliberative process, and a reliance on expert advisors. Ultimately, the record should reflect an active and thoughtful special committee that devoted significant time toward evaluating, negotiating, and approving or rejecting the proposed transaction.

Seek Best Value

If directors conclude that a change-in-control transaction is in the best interests of the company and its shareholders, the directors should seek to obtain the best value available for the company. Courts have recognized that there is no single method or roadmap for fulfilling the directors' duty to maximize value once they decide to sell the company. Directors should consider inviting bids from multiple prospective buyers so that there is a "market check" regarding the adequacy of the transaction terms. At times, directors may need to put protective measures in place so that no bidder obtains an unfair advantage over other, potentially more lucrative bids. The directors should generally avoid agreeing to an absolute, locked-up deal (without a so-called "fiduciary out") prior to confirming that the proposed transaction is superior to other potential deals. Once a bidding process begins, the directors should generally make available the same information and impose the same deadlines on all potential bidders to avoid the appearance of preferring

one bidder to another. However, under appropriate circumstances, directors can prefer one bidder to other bidders or not pursue a bidding process if by doing so the directors are reasonably pursuing the goal of obtaining the best value for the company. Directors can tilt the playing field toward a particular bidder consistent with this goal but should not do so for reasons unrelated to obtaining the best value for the company.

When determining the best bid after having decided to sell the company, directors need not look solely at the price per share for each bid. Rather, directors may appropriately analyze the entire context of each bid, including the nonmonetary terms of the offer, the bidder's financing for the transaction, the risk of nonconsummation, the bidder's identity and prior experiences, and the bidder's post-transaction business plan for the company. In a noncash transaction, directors should also analyze the current and projected future value of the securities being received in the transaction.

Important to this evaluation process is the reliance upon a fairness opinion from a qualified and disinterested investment banker. That fairness opinion should reflect various alternative valuation methodologies, including a comparison of comparable transactions, a review of historical earnings, and a discounted cash flow analysis, as well as appropriate control premiums (that is, the amount in excess of the target's current stock market price that the acquirer should pay to reflect the value of a controlling interest in the target). Directors should consider the reasonableness of the assumptions behind the fairness opinion and whether the investment banker relied on reasonably complete and accurate information about the company in reaching its opinions. The minutes should reflect that the investment banker had a meaningful and in-depth discussion with the directors regarding the fairness opinion.

Directors should also be involved and should oversee the process of soliciting alternative bidders. If the directors conclude that a transaction should occur, the directors should consider a formal, coordinated process during which strategic bidders both within and outside the company's industry, private equity investors, and other alternative transaction structures are considered.

Disclosures

M&A transactions create challenging disclosure issues for directors with respect to when the proposed transaction should be publicly disclosed, what information should be included in that public disclosure, and how the confidentiality of information should be maintained before that public disclosure.

- **Timing of Disclosures**—Courts have not identified clear guidelines for determining when a proposed M&A transaction should be disclosed. Premature disclosure of the transaction may jeopardize the negotiation of the transaction and may mislead investors into believing the transaction is likely to occur. On the other hand, delinquent disclosure may harm investors who sell their shares while the secret acquisition negotiations are occurring. Instead of adopting a bright-line rule concerning when the negotiations should be disclosed, courts generally apply a case-by-case analysis that weighs the probability that a transaction will occur and the magnitude of the effects of the transaction. Generally, the higher the probability and the greater the effects, the more likely disclosure is required.
- Directors should seek advice from qualified legal counsel regarding this rather subjective but very important analysis. In addition, to avoid inadvertent

mistakes relating to disclosures, all persons involved in the proposed transaction should be informed that all public comments by or on behalf of the company should occur through a designated spokesperson, who should obtain approval from qualified legal counsel before saying anything. Directors should coordinate the timing and content of their disclosures with the timing and content of disclosures by the other parties to the transaction so that all public communications by all parties are consistent.

- **Content of Disclosures**—Shareholders who file lawsuits with respect to proposed transactions typically include claims alleging the directors misrepresented or omitted material facts regarding the terms, negotiations, and impact of the proposed transaction. The proxy materials relating to the transaction should contain a thorough, detailed explanation regarding the history of the directors' consideration of the transaction, the reasons the directors recommended the transaction, the terms of the transaction and its financing, the material conditions for closing the transaction, and the likely impact of the transaction on the company and its shareholders. For example, the disclosures should describe the content of the fairness opinion from the investment banker, including the valuation methodologies used; the assumptions and projections underlying the analysis; and any limitations on the opinion. The disclosures should also include a description of factors that could have affected the process the directors used or the advice any of the expert advisors rendered, including financial incentives or other arguable conflicts of interest. These disclosures should include both factors inherent in any acquisition transaction and unique factors applicable to the specific transaction. The more complete and candid the disclosures, the more likely directors will be

able to successfully defend disclosure claims by shareholders.

- **Confidentiality**—The number of people with access to information about the proposed transaction should be controlled and limited to minimize the risk of selective or improper disclosure of nonpublic information. All such persons should be expressly informed of the strictly confidential nature of the information and forbidden to disclose that information to any person without prior approval. Particularly, nonemployee advisors should sign a confidentiality agreement before receiving any information or otherwise becoming involved in the proposed transaction. Similarly, the prospective bidder should sign a strict confidentiality agreement that prohibits the bidder from using or disclosing information about the company or from disclosing information about the proposed transaction without the prior consent of the company.

Going Private Transactions

Transactions in which a public company converts to a privately held company present heightened liability risks for directors because of the inherent conflicts of interests that frequently exist. The buy-out group often includes senior officers and can in many cases exert considerable influence over the transaction. If directors do not take extraordinary precautions to assure the transaction process is truly free from conflicts of interest and an appearance of independent decision making exists, the directors may lose the protection of the business judgment rule and instead be forced to prove the entire fairness of the transaction.

There has been a surprising dearth of case law which would provide guidance on such transactions; however,

the following has been suggested as a roadmap for directors travelling down this private transaction path. At a minimum, the transaction should be (i) negotiated and approved by a fully empowered special committee of disinterested directors who will have no ownership in the private company and who are independent of the private company's prospective shareholders, and (ii) conditioned on the approval by a majority vote of the selling shareholders even if that approval is not legally required and even if the selling shareholders hold a minority of the outstanding shares.

The special committee should be authorized to select its own legal and financial advisors, should be thorough in its investigation and analysis, and should be free to say no to the transaction if it is not in the best interest of the company or the selling shareholders. Persons who would benefit from the transaction, or who are affiliated with such persons, should be completely removed from the special committee's activities. Likewise, the vote of the selling shareholders should follow full disclosure of all material information and should be free of any threat of coercion or retribution if the transaction is not approved.

Business Operations

Directors should implement reasonable practices designed to prevent the proposed transaction from unreasonably interfering with the company's ongoing operations. Employees selected to perform due diligence or otherwise support the directors' deliberative process should not be expected to play critical roles in the day-to-day operations of the company at the same time. Instead, their management responsibilities should be delegated to other appropriate managers where necessary. A large percentage of proposed transactions never close, so

directors should seek to minimize any adverse impact on the company caused by an unsuccessful transaction proposal. Both the pursuit of the proposed transaction and the continuing business operations are important functions that should be managed so that one does not jeopardize the other.

Anticipate Litigation

In today's legal environment, there is a very high likelihood the directors of the target company will be sued once a proposed acquisition transaction is publicly announced. As a result, the target company should consider various pre-litigation strategies to enhance the administration and defense of that litigation.

For example:

- Prior to the litigation being filed, the target company can consider amending its bylaws or charter to add a provision that designates a specific jurisdiction as the exclusive venue for all shareholder lawsuits involving governance issues. This provision, if enforceable, might help prevent multiple lawsuits against the target's directors in multiple states and thus might avoid duplicative defense efforts and the risk of inconsistent rulings from those multiple courts.
- The directors collectively can consider and potentially retain in advance appropriate defense counsel to represent them in anticipated litigation, thereby minimizing any confusion or debate once the litigation is filed. It is preferred that all defendant directors retain the same defense counsel (absent a conflict of interest among the directors) in order to minimize defense costs and assure consistent defenses.
- The target company should develop and distribute to relevant parties an external communication protocol

that funnels external communications relating to the acquisition and litigation through a designated person who is properly trained and has access to qualified advisors.

- At the beginning of the takeover process, the directors should receive detailed training regarding their responsibilities, the likely sequence of events, recommended governance practices, and various best practices relating to the proposed transaction. Once directors understand the overall context of their actions, they can better apply their common sense to avoid many of the natural pitfalls.

Financial Protection

Unique and difficult issues can arise when structuring a comprehensive D&O financial protection program in the M&A context. The following indemnification and insurance issues should be addressed.

Indemnification

Indemnification issues in a change-in-control situation are challenging because a person's right to indemnification is determined when the directors and officers incur the loss, not when the alleged wrongdoing occurs or when a claim is made against the directors and officers. Losses arising out of preacquisition wrongdoing can be incurred years after the acquisition. Because directors and officers of the target will no longer control the target company following the acquisition, they need to lock in their future indemnification rights before the acquisition is finalized. That can be accomplished through a combination of two strategies.

First, prior to the acquisition, the target company can include in its mandatory by-law indemnification

provision a clause stating that the by-law indemnification rights and obligations are contractual in nature, which prohibits the company from retroactively amending or repealing the indemnification rights of directors and officers with respect to any alleged wrongdoing that took place before the acquisition. Second, the acquisition agreement should include a provision requiring the acquiring company to advance defense costs and to indemnify the former directors and officers of the target company to the fullest extent permitted by law.

Insurance

Structuring an appropriate D&O insurance program for an M&A transaction is fraught with difficult challenges because of both the number of issues that should be addressed and the inherent conflict between the interests of the target company's former directors and officers and the surviving company. The following discussion summarizes many of those issues.

To ensure the existence of continuing claims-made coverage for the directors and officers of the target company after the transaction closes and after those directors and officers leave office, the target company should purchase prior to the closing a prepaid, noncancelable, extended run-off insurance policy that cannot be amended or affected in any way by the acquiring company or subsequent management. Frequently, the term of such a run-off policy is six (6) years.

This type of run-off policy is more protective than a provision in the acquisition agreement that requires the acquiring company to maintain D&O insurance for the former directors and officers of the target company. If the acquiring company intentionally or inadvertently breaches that provision or is unable to maintain such

coverage (because of its financial condition or market conditions), the former directors and officers of the target company can be left uninsured through no fault of their own. That risk is eliminated if the target company purchases a prepaid, noncancelable, long-term run-off policy prior to closing.

To afford maximum protection, a D&O run-off program typically includes both standard D&O insurance policies, which cover claims against directors and officers whether or not the claims are indemnified by the company, and a broad-form, Side-A policy, which covers only nonindemnified loss incurred by the directors and officers). That type of program structure insures to varying degrees both the acquiring company's potentially large indemnification liability arising from pre-acquisition wrongdoing by the target company's directors and officers as well as the nonindemnified losses of the target's directors and officers. Importantly, the Side-A policies in that program structure afford far broader coverage than available under a standard D&O policy, are not diluted by the company's indemnification obligations or other company losses, and are not frozen if the company later files for bankruptcy.

Other issues to consider when structuring a run-off D&O insurance program include the following:

- What entity is the insured company for purposes of the coverage for indemnified losses? Whichever entity is obligated to indemnify the target's directors and officers after the closing should be an insured company under the run-off program.

- Are claims by the acquiring company, which may be an insured company, excluded from coverage by reason of an “insured vs. insured” exclusion in the run-off policy?
- Do the target’s directors and officers have full coverage (without any retention) if the acquiring company is permitted or required to indemnify the target’s directors and officers but fails to do so?
- How does the run-off policy respond to a claim that alleges both wrongdoing by insured persons prior to closing, which is covered under the run-off policy, and wrongdoing after closing, which is not covered under the run-off policy? The acquiring company’s D&O insurance program typically insures the target’s directors and officers only for wrongdoing committed after the acquisition, so the target’s run-off policy and the acquirer’s going-forward policy should be coordinated to avoid gaps in coverage or difficult allocation issues between those policies.

Conclusion

Sound governance practices relating to M&A transactions often begin long before a potential change-in-control transaction is pursued or proposed. Directors should anticipate and consider the issues described above, ideally before an M&A transaction arises, and should have a general familiarity with how they will initially design a process to address a potential transaction. Because a crisis management atmosphere may develop once a potential acquisition is identified, waiting until that time to analyze these issues could affect the quality and availability of an appropriate risk management response to the transaction.

About the Author

Dan A. Bailey, Esq., a member of the Columbus, Ohio, law firm Bailey Cavalieri LLC, is one of the nation's foremost experts on matters relating to directors and officers (D&O) liability, litigation, and insurance. He and his firm have represented or served as a consultant to a wide variety of directors and officers, corporations, insurance companies, insurance brokers, and law firms around the country regarding D&O matters.

A frequent speaker at seminars throughout the country regarding D&O liability and insurance, Mr. Bailey is also the coauthor (with William E. Knepper) of *Liability of Corporate Officers and Directors*, and he has written dozens of articles on the subject.

Mr. Bailey received his B.S. degree in business administration cum laude from Bowling Green State University in 1975 and was awarded a Juris Doctorate degree with honors from the Ohio State University School of Law in 1978. He is a member of numerous honoraries and was selected for inclusion in *Who's Who in America*.

Chubb. Insured.SM

Chubb is the marketing name used to refer to subsidiaries of Chubb Limited providing insurance and related services. For a list of these subsidiaries, please visit our website at chubb.com. Product highlights are summaries only.

Please see the actual policy for terms and conditions. Products may not be available in all locations, and remain subject to Chubb's underwriting criteria. Surplus lines insurance is sold only through licensed surplus lines producers.

Form 14-01-1099 (Rev. 6/16)