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Idea Exchange: Extended Reporting Provisions

Complexities That Arise with ERPs: Part 2

For specialty line insurance policies such as directors and officers liability, professional liability, cyber liability etc., claims made insurance policies are the most common type of policy issued. They are complex, and depending on the definition of claim, as well as whether or not it's a claims made and reported form, the policies can be extremely dangerous.

By Frederick Fisher

What follows is the second installment of a three-part series on the complexities inherent in claims made policies with extended reporting provisions (ERPS). The previous article, It's Just a Name Change and Other 'ERPS,' published in the May 22, 2023, edition of Insurance Journal, addressed various problems that may arise when the need for an ERP is triggered because a client decides to simply change the name of their business — or intends an organizational change to the business — and the differences between the two.

Additional and Subtle Complexities

This article takes up where the previous one left off — with a discussion of the additional and subtle complexities involved when an ERP is triggered.

Traditionally, an ERP has been triggered by either cancellation or nonrenewal, or a change in control of assets, operations, or sale of the stock of the company.

There are inherent dangers when a company is acquired, not only for the selling company but for the acquiring company, as well. It is not uncommon for the buyer to require the seller to purchase several years of ERP coverage. This is because the buyer, when either acquiring the assets or the stock transaction, wants no exposure to any known or unknown liabilities created by activities that occurred before the acquisition. The buyer will only want to be protected on a go-forward basis, whether the acquisition is asset-based or stock-based.

There is an inherent problem with this traditional thinking, but more on that follows below.

Still, it is quite a common provision. We've all seen companies get acquired, with the seller invoking whatever extended reporting coverage they can acquire, sometimes at a significant price. That makes the buyer happy to know that there is security for any litigation that may take place arising out of a wrongful act that took place before the transaction. But that is not the only problem, and this is where the approach and analysis become important.

Asking the right questions is necessary to provide the appropriate financial protection to those involved, with the avoidance of any error and omission (E&O) claim that might be made against the broker, despite whether they are simply following an "order take" standard or not.

Is Time or Cost of an ERP Important?

All too often insurance brokers are the last to know of an impending transaction. If, by some miracle, the broker is involved early on, significant coordination can take place.

One of the first things a broker should ask is what's important to the seller — is it the length of time of the extended reporting provision, or the cost of the ERP? For instance, it may be possible to alert the existing underwriter that a transaction may take place. One might ask the underwriter that instead of the policy automatically going into ERP, which would expire at the usual anniversary date, would the underwriter allow the policy to be canceled at 11:59 PM on the day before and allow any unearned premium to be applied to the cost of the extended reporting provision with no cancellation penalty?

The ERP would equally have to be ordered to allow for the intended continuity. Thus, the cost of the ERP can be reduced. That assumes that cost is a driving factor.

If, however, the policyholder wants to maximize the amount of time of the ERP, they can allow the policy to automatically go into runoff mode until the anniversary date and then buy an ERP, at the appropriate time, whatever length of time is offered and can be afforded. Depending on when the transaction closes, of course, could add significant time to the policy in that scenario.

The Subtleties Continue

Where this can become complex is when a name change and/or operation change and/or ownership change arises with the sale of assets or stock. When dealing with claims made policies, a substantial sale of assets, or an acquisition or sale of the company stock constitutes a change in control and/or a change in operations. This immediately, by most policy conditions, automatically triggers the policy into runoff mode until the policy would normally expire but only for claims first made during the policy terms but only for wrongful acts committed before the transaction date.

The existing policies of the buyer would normally cover any wrongful acts that take place after the transaction. Sometimes, though, a new "go-forward" policy (with prior acts of inception) might be necessary. Hence, initial questions can identify the need and the appropriate solution.

One more item is generally true. It is usually not an "either/or" proposition — one may need both, an ERP and a "go-forward" policy.

'C' Corporation Issues

Another scenario is when there is a sale of assets or sale of stock. Here again, the need for an ERP can be triggered simply by a request for name change, when there actually is more going on. Once it is determined that it is not just a name change but a new entity, many scenarios need to be explored.

Foremost, is the corporation itself a "C" Corp. or an S-Corp.? If it's a C corporation, then one must determine whether only the assets are being sold or if the stock is being sold. The answer to that will significantly determine the approach to be taken, especially since the usual scenario with a C Corp. is based on avoiding double taxation. Usually, it's a sale of assets.

Sometimes, it will be a stock sale to avoid double taxation by the buyer. If it's a stock sale, the solution is obvious. A runoff or ERP tail must be obtained for the years that might be available, with the additional query as to whether additional years might be available at an additional premium. The buyer's coverage(s) generally will pick up the go-forward exposure.

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However, the transaction will likely be an asset sale with the buyer avoiding inheriting any unknown problems or liabilities. That still triggers the runoff provision but changes the approach.

Is the selling corporation going to be immediately and simultaneously dissolved with the funds immediately distributed to stakeholders and shareholders? If not, that means a corporation will continue operating if for no other reason than to distribute the assets as a "wind-down operation." But the corporation itself may decide it wishes to enter a new business venture, i.e., a change of operations to avoid violating any noncompete clause that probably exists in the terms of sale documents.

If so, then a go-forward policy, with prior acts coverage of inception, in addition to ERP tail, will be required. Since the operations have changed dramatically, it is doubtful that an underwriter would continue the claims made coverage as it exists. That means they would still need to buy an ERP for as many years as may be available. In addition, a go-forward policy to cover any wrongful acts committed after the transaction will be necessary.

A go-forward policy would insure the "old corporation," as the FEIN number had not changed. Coverage would be provided for "new operations," either due to wind-down exposures, or the company seeking new opportunities in a new business environment. Subject to the usual underwriting guidelines, the go-forward coverage would be renewable year after year.

S-Corporation Issues

If it's an S-Corporation, a similar analysis is necessary. There, and subject to the usual tax liabilities, there is no double taxation when one sells the assets or a significant portion thereof. The same questions, however, apply.

A tail policy probably will be required and thus extended reporting coverage must be purchased for as many years may be available from the insurer, and as one is comfortable obtaining and paying for. Yet, again, what will happen with the funds received? Is the company going to be immediately dissolved if it's an asset sale only and the money flows to the stakeholders and shareholders and/or creditors? If not, is the company going to continue any operations even if it's a wind-down operation as opposed to some continuing new business? If so, then again, a similar approach needs to be taken in addition to purchasing extended reporting coverage. This would mean that a go-forward policy would still be necessary to cover any wrongful acts committed during the wind down process or if the company continues operating with the change in operations.

Non-Conforming 'Partial' Sale of Assets or Stock, and a Name Change or Not

There is still another scenario. That is where the S-Corp. sells substantial assets and thus could trigger the change in control provision, which would require the purchase of an extended reporting provision. However, there may be a change in operation or what was a minor part of the company now becomes the major operation of the company post sale. A name change might take place, too, yet the FEIN number would not change. It is still the same corporation but is now operating under a new name/DBA. That means it still

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is the same corporate shell presumably with the same senior managers.

Still, it is mainly a name change as the corporate shell remains the same. What if the operations of the company are not that much different from the original operations? Would an extended reporting provision be necessary and a new go-forward policy under those circumstances?

Consider a company that has two functionalities, and when selling the assets, one function of the company is sold off. But the other operation is not competitive or competing with the operations sold. Is it necessary to buy tail and a go-forward policy?

Some underwriters might deem that the case and not be willing to do anything other than offer an extended reporting provision and a go-forward policy. Some underwriters may decide that the operations maintained by the original owners are such that they will not underwrite it, requiring the insured to purchase an extended reporting provision and seek a new go-forward policy from another insurer.

These need to be addressed and be looked at before the sale. If they are significantly similar to what the insurance company had covered, they may decide not to require an extended reporting provision and a new go-forward policy. They may simply continue the coverage as is. This is where the complexity arises.

One thing is for certain, if a corporation simply sells assets and changes its name, it has not necessarily changed its corporate structure. If there is no change in officers and directors or only a minor change, coverage might continue. However, all this needs to be disclosed to any underwriting facility at risk and any new one for the final determination as to whether they agree that the risk has not been significantly increased as opposed to decreased. These are subtle issues. Still, the approach is clear and the response by the underwriters will determine the best approach for the policyholder.

Thus, a potential solution becomes clear. Is it possible to obtain one policy that still covers the entity as is, or will it be necessary that an extended reporting provision be purchased, as well as a go-forward policy, to cover any future wrongful acts? This will be determined case-by-case. IJ

Note: The above is the second article in a three-part series on complexities that may arise with claims made policies involving extended reporting provision (ERP) coverages.

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