M&A Due Diligence For Engineering Firms

Commonly Overlooked Insurance Concerns

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Mergers and acquisition (M&A) activity has accelerated in the architect, engineers, and contractors (A/E/C) space with a strong uptick in activity in 2021 which is expected to continue into 2022. The process of merging with or acquiring a new firm is complex and requires heavy due diligence. An important aspect of the due diligence process is the consolidation of, or, in some cases, a conscious decision not to consolidate, the buyer's and seller's insurance programs to ensure that there are no uninsured liabilities or gaps in coverage post-closing.

Source: Morrissey Goodale, 2021 AE M&A Year-in-Review

Based on our experience as an insurance brokerage and risk management firm specializing in A/E/C industries, below are the areas of insurance that are often overlooked during the due diligence process which, if not properly recognized, could have severe financial consequences to the buyer.

- Professional Liability
- Technology Errors and Omissions
- Workers' Compensation
- General LIability
- Cyber Liability
- Representations and Warranties Insurance
- When Not to Consolidate Insurance Policies

Professional Liability

The bulk of an A/E/C firm's exposure is covered under the professional liability (PL) policy. The first step to ensuring that the consolidation of this line of coverage occurs smoothly and to avoid any under-insured or uninsured liabilities is to determine the structure of the deal, and whether it will be an asset-only or a stock transaction. The elected deal structure has an impact in determining which party is responsible for pre-existing liabilities which can be addressed through the procurement of a tail policy, also referred to as an extended reporting period (ERP). A tail policy allows for an insured to report claims that are made against them after a policy has expired or been canceled as long as the wrongful act that gave rise to the claim took place during the expired or canceled policy period.

Tail policies are typically purchased by sellers in asset purchase transactions since pre-existing liabilities remain with them, meaning that the seller is responsible for future claims that arise from work performed prior to closing. This is usually backed up by an indemnity in the purchase agreement. If tail coverage is not purchased by the seller and a claim were to arise after closing for work performed by the seller prior to closing, then there would be no insurance coverage on either the seller's cancelled Professional Liability policy - as it is no longer in effect - nor the buyer's current Professional Liability policy in place, which would only provide coverage for claims that arise post-closing.

Our recommendation to buyers is to require sellers to purchase tail coverage even in asset-only transactions to avoid any uninsured liabilities and future uncertainty with courts potentially assigning liability to the buyer even with a purchase agreement in place outlining the seller's responsibilities.

For stock transactions, there are generally two ways to address the pre-existing liabilities of the seller. The buyer can either integrate the full prior acts of the seller into their existing professional liability policy, or they can procure tail coverage through the seller's professional liability policy and schedule excess coverage over this tail on their current professional liability policy. Most buyers elect to integrate the full prior acts of the seller into their existing policy as this is usually the cheaper option. However, the procurement of separate tail coverage should more often be considered for stock purchases so that the cost of the transaction (and its liabilities) is fully accounted for and does not create later balance sheet issues, especially if the buyer is involved in several transactions each year.

Insulating the seller's pre-existing liabilities through the procurement of a tail policy as opposed to integrating them protects the buyer's professional liability loss history, a factor insurers evaluate at renewal. A large claim brought against the seller post-acquisition for work done pre-acquisition would have an undetermined effect on the buyer's future

professional liability renewal pricing. The seller's tail options are usually outlined in their professional liability policy with various options ranging from 1 year to 5 years. The buyer's professional liability policy is then modified to pick up the past work of the seller (since they are buying the seller's liabilities), but excess of the seller's tail policy which acts as primary insurance. Any new work performed is picked up under the buyer's professional liability policy on a going forward basis.

Some buyers elect to purchase the shortest tail option available to reduce costs at the time of the transaction, which we do not recommend, particularly since an A/E/C firm's exposures for claims extends well past the expiration date of a particular policy period as claims are generally made several years after work is performed. Additionally, once the decision on the length of the tail is made at closing, it cannot be extended at a later date. Our advice to buyers in stock transactions is to purchase the longest available tail option on the seller's professional liability policy (or at a minimum 3 years). Purchasing a longer tail option to remain in place during the lag time between when work is performed and a claim is made isolates a good portion of the exposure from the buyer's professional liability program, as the tail policy acts as a buffer before the buyer's professional liability policy responds.

Our firm has seen a number of large claims filed under tail policies which protected our client's professional liability loss history and minimized any impacts on future renewals. For example, a seller firm worked on a project where they provided surveying and staking services prior to closing. The firm used inaccurate reference points which resulted in errors during the staking of the site, but these errors were not discovered until 2 years later after the site had been graded. If the decision was made during due diligence to purchase the shortest tail option available of 1 year, then there would be no coverage under the seller's program and the buyer would have to assume the liability and subsequent costs associated with work performed by the seller pre-closing.

Another recommendation is to have the buyer's insurance broker become the broker of record (BOR) of the tail policy to control the placement of the tail and the servicing that comes with it. This includes filing claims, obtaining sensitive loss information, and the coordination of complex mixed claim scenarios in the event that a claim or circumstance triggers both the seller's tail policy and the buyer's professional liability policy.

Technology Errors and Omissions

For A/E/C firms merging with or acquiring a firm that provides technology services or products, one of the fastest-growing industries worldwide, a careful examination of the seller's technology errors and omission (Tech E&O) policy and most recently completed application must be conducted by your insurance advisor to understand all services provided by the seller. If the buyer firm does not already have a Tech E&O policy in place, a thorough analysis of the seller's services should be performed to determine if there is coverage under the buyer's PL policy. Some policies exclude technology-based services or software products altogether, while others may provide limited tech coverage but do not have an adequate definition of professional services to pick up all services provided by the seller.

Moreover, other insurers may exclude consulting services (which are covered under professional liability policies) if it pertains to technology-based consulting services - an important distinction. A/E/C PL insurance policies usually do not provide adequate coverage for tech services and relying on this policy alone could be a risky decision.

Our recommendation for A/E/C firms looking to move into the tech industry via a merger or acquisition is to have your insurance advisor perform an in-depth analysis of all services provided by the seller. New policies or significant amendments to current policies in place will most likely be needed in order to avoid uninsured liabilities post-closing.

Workers' Compensation

Each year, the National Council on Compensation Insurance (NCCI) issues a new experience modification rate (EMR) for eligible businesses comparing its actual loss experience against the expected loss experience of other businesses in their classifications and states based upon data collected from millions of workers' compensation claims and policies. This rate must be used by insurers to calculate premiums for workers' compensation policies in about 40 states. When one firm purchases another firm, assuming they both have NCCI EMR's, the acquiring firm is also purchasing the loss experience of the target firm, meaning that they are also buying their workers' compensation payroll, classification, and loss history. This, in turn, impacts the buyer's EMR.

NCCI has specific rules as to combinability, with ownership being the principal driver. Firms under common ownership (even if the % of ownership differs) generally must have their payroll classification and claims experience combined for EMR purposes. This is most commonly determined by a specific NCCI form detailing ownership and the combination,

which NCCI uses to set combinability. With few exceptions, NCCI's determination is not challengeable. In a stock acquisition, integration of the seller's EMR with the buyer's EMR post-closing is an insurance issue often overlooked during the buyer's due diligence process.

The resulting effects can be serious both in terms of increased premiums and potential loss or ineligibility of work. For example, a buyer firm with an EMR of 0.89 purchased a firm with an EMR of 1.15. The transaction was reported to NCCI in accordance with the rules governing business combinations, and the buyer's EMR increased to 1.05. This resulted in a $30,000 additional premium at audit time and an increased premium in subsequent renewals. Additionally, since the buyer's EMR is now above a 1.00, their bids on 2 jobs were rejected by large industrial clients who have strict rules preventing any vendor with an EMR over 1.00 to work on their sites, resulting in a $1.2M loss in work.

While it is common for buyers to request a copy of the seller's loss runs detailing claims during the due diligence process, it is uncommon for buyers to request a copy of the seller's current Experience Rating Worksheet which outlines the firm's EMR rating, including policy audits for three years. This data enables a broker to predict the combined buyer and seller EMR.

High EMR's are not solely attributable to one-off, large losses. Claim frequency, even if it results in relatively small claim amounts, can also push a firm's EMR over 1.00. In fact, based on the way that NCCI calculates EMR, high frequency, smaller losses can push a firm's EMR higher than a single large loss would. Based on the many variables that go into how EMR is calculated, viewing loss runs alone will not provide enough insight to the buyer's insurance broker to determine the impacts that the transaction will have on the buyer's EMR post-closing. Due to the many implications of an increased EMR, it is recommended for stock acquisitions that a full analysis of the impact of the seller's workers' compensation payrolls, classifications, states of exposure and claims experience on the buyer's EMR is performed as part of the due diligence process.

General Liability

For contractors merging with or acquiring another firm, an important coverage to consider during the due diligence process is completed operations coverage for discontinued operations, which can be thought of as a tail policy for general liability. This policy provides coverage for incidents of bodily injury or property damage to a third party arising after a business is no longer operating. It is important for sellers to investigate this

coverage if the buyer has included as a condition of sale that they will not assume liability for any injuries caused by work performed prior to the date of sale.

This coverage can also be advantageous for the buyer to procure on behalf of the seller if the buyer wants to protect itself against future bodily injury or property damage claims that arise out of work performed by the seller prior to the closing date as this policy effectively separates the seller's past work exposure from the buyer's general liability policy. This coverage can be expensive, but usually decreases by a certain percentage each year, as the risk of liability falls overtime in relation to the statutes of repose in the states of exposure. However, the cost of the policy can be justified in many cases, particularly for contractors with high general liability rates as the buyer's insurer will price the addition of the combined firm's exposures at a lower rate knowing that they are not responsible for past exposures of the acquired firm.

As with professional liability, our recommendation is to have the buyer's broker become the broker of record to control the placement of the policy and the service that comes with it. This includes claims filing, obtaining sensitive loss information, and the coordination of complex mixed claim situations if a claim or circumstance triggers both the seller's completed operations coverage for discontinued operations and the buyer's general liability policy.

Cyber Liability

Another line of coverage where tail insurance is often missed during the due diligence process is the cyber liability policy. Potential claim scenarios covered by a cyber tail are not as intuitive as with professional liability and general liability. However, in today's world where cyber claims are on the rise, we recommend that tail coverage be considered for cyber liability as well.

For asset transactions, the ideal course of action is to fold the seller entity into the buyer's cyber liability policy effective on the date of the acquisition with full prior acts coverage. If the buyer's cyber insurer does not agree to full prior acts, then the tail option on seller's cyber policy comes into play.

For stock transactions, we recommend procuring tail coverage on the seller's cyber policy as potential unknown liabilities relative to data and privacy can exist after closing which would not be covered under the buyer's policy. Claims scenarios that would be picked up under the tail policy, but not under the buyer's cyber policy post-closing are usually related to liability due to wrongful acts resulting in misappropriation of data, as opposed to

ransomware or hacking. For example, an employee of the seller entity left plans out pre-closing which were then sold to third parties, but the act was not made known until post-closing. In this scenario there would be no coverage under the buyer's policy. Without the purchase of a tail under the seller's policy, this would result in an uninsured liability that would be absorbed by the buyer. The cleanest way to address any unknown liability due to pre-transaction acts or negligence that manifest in alleged liability is through the procurement of tail coverage on the seller's policy.

Representations and Warranties Insurance

For larger transactions, there is a specific insurance product on the market, representations, and warranties insurance, which provides protection against financial losses for certain unintentional and unknown breaches of the seller's representations and warranties made in a merger or acquisition agreement. We make the distinction of "larger transactions" as the cost for this insurance - which typically ranges from 2.5% to 5% of the coverage limits - generally is not justified for smaller transactions.

The product is unique in that limits and retention can be negotiated with the insurer and responsibility for the retention can be split between the buyer and the seller. When the product was first introduced, many insureds were suspicious that an insurer would cover these types of claims; however, over the past several years, we have seen insurers pay valid claims under these policies allowing insureds to feel more comfortable relying on this insurance.

The product is available for both buyers and sellers and provides key benefits for both sides. For a buyer-side policy, this insurance offers additional protection beyond the negotiated indemnity cap and survival limitations in a purchase agreement. For a seller-side policy, this insurance can reduce the amount of funds held back in escrow. It's important to note that this insurance is not a catch-all product and policies are issued with standard exclusions, such as known breaches. Additionally, the insurer will conduct detailed underwriting for each deal, and may also add transaction-specific exclusions, which can include professional liability, cyber liability, and directors and officers exclusions.

When Not to Consolidate

For some transactions, the conscious decision may be made to not consolidate the buyer's and seller's insurance programs. One example would be if the seller's services are riskier than the buyer's portfolio and falls outside of the appetite of the buyer's insurers.

Types of risk that could potentially make insurers hesitant include the performance of construction or remediation activities, large vehicle fleets, and poor loss history. Another example would be if the target firm provides technology services involving heavy software and technology exposures. In this situation it may be preferable to keep the technology-based insurance program separate from a more traditional engineering program to ensure that the digital risks are adequately covered.

International acquisitions are another example of when it can be beneficial to keep the seller's insurance program in effect, particularly if the buyer does not already have a local insurance program in place or a local presence. In these cases, the buyer can usually be added as an additional named insured on the seller's local program and the policies can remain in effect rather than cancelling the program at closing.

Finally, if the transaction is set up as a partial ownership acquisition where the buyer is not purchasing 100% of the seller firm, then the best route may be to keep the insurance programs separate as well.

It is important to note that in each of these situations, the seller's insurers must be fully aware of the transaction as many insurance policies include "change-in-control" or similar provisions which restrict or eliminate coverage due to changes in ownership. We strongly advise engaging both the buyer's and seller's insurance brokers when contemplating the idea of maintaining separate insurance programs post-closing to avoid any unintentional gaps or full loss of coverage.

Conclusion

Mergers and acquisitions require a significant amount of due diligence. Insurance plays an important role in the process to assist buyers in evaluating risks. Insurance brokers should be conducting an in-depth review of the target firm's business profile and services to identify and understand the exposures and key risks associated with them. A thorough review and assessment of the seller's insurance program should also be conducted and a summary of key policy provisions including insuring agreements, definitions, exclusions, and conditions along with the claim reporting provisions should be provided to ensure customary coverages relevant to the seller's industry are included. This also assists in identifying under-insured or un-insured risks and how to best manage them.

A full analysis of pending claims should also be conducted to assess potential exposure and the applicability of coverage. Additionally, your insurance broker should provide advice on how best to consolidate exposures or assist buyers with the conscious decision to not

consolidate programs. Insurance products needed to adequately insure exposures, mitigate risks, and facilitate transactions should also be evaluated and recommended if necessary.

There are numerous factors for insurance brokers to evaluate and consider to ensure that there are no gaps in coverage or under-insured or un-insured liabilities post-closing. It can be costly and detrimental to the success of a transaction if these factors are not properly evaluated. As an insurance brokerage and risk management firm specializing in the A/E/C industries, we partner with buyers and their legal team to provide our expertise, conscious advice, and accumulated experience to guide them through the mergers and acquisitions due diligence process.

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