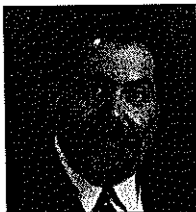
Corporate Exposure: Contingent Liability



Harry P. Mirijanian

As the business world continues to consolidate into mega-corporations with worldwide operations, mergers and acquisitions have hit an all-time high. A by-product of the furiously paced M&A strategy has been an increase in contingent liability lawsuits. The lawsuits stem primarily from product, environmental, and employee benefit liabilities. Our discussion will focus on these issues, but note that the entire spectrum of risk management exposures has been tested.

Several factors are responsible for the rise in product liability lawsuits. An organization over its history may have produced thousands of products; an acquiring organization probably will not be aware of many of these. Or perhaps the acquired company may produce one small component of a much larger product. The result: A new owner may be involved in a lawsuit if the acquired company is sued. There have been claims in which a component of a product is now deemed harmful—which leads to a suit. Several states have laws that provide for contribution rights among multiple manufacturers of a product. Warranties and guarantees can often leave the firm exposed for the lifetime of the product.

Acquiring companies should review all product liability claims (opened and closed), reserves, the basis of the lawsuits, any product redesigns due to deficiencies (whether real or perceived), and, if possible, customer complaint letters and allegations. Naturally, an analysis of all prior product liability policies should be conducted to determine the extent of past coverage. Product liability recall is another important issue. The acquired company, or seller, is responsible for product recall costs and liabilities although usually for a fixed dollar amount. There have been instances in which new owners have instituted product recalls to protect or preserve their corporate image with little regard to recall costs for precisely this reason. To avoid this, some type of contractual wording differentiating between mandatory and voluntary recalls is appropriate.

Another source of litigation stems from environmental/pollution exposures. It could create complications if a site has had several owners over the years. Review real estate records and lot plans during your analysis. As laws differ outside the U.S., the pollution exposure can vary dramatically. Environmental standards should be based upon the most stringent guidelines available, not merely the minimum standards set forth by a particular country. Unfortunately, many firms operate only to compliance levels.

Changes in the law now ban certain substances and require retro-fitting or substitution of chemicals and components. What seems an environmentally safe product could be rendered hazardous.

Contingent liability claims have also been associated with employee benefits programs that contain certain provisions extending benefits well into the future. Retirees from a newly acquired firm may have been provided certain privileges of which the new owner is unaware.

The key to controlling this sort of exposure can be stated in two words: *due diligence*. Develop a team of professionals, experienced to perform this type of extensive review, and be sure to examine the following issues:

- ***Records retention.*** Review the quality of the program—in particular, document destruction and retention schedules. How long are documents, memos, customer complaints, blueprints, etc. retained? These items might possibly increase your liability in some claim defenses—but they could also prove invaluable in others.
- ***Insurance policies.*** Models of all prior coverages to document potential gaps or inefficiencies in coverage are critical. Some computer analyses of policies permit plotting of coverages to highlight specific areas of concern. Insurance archaeology professionals used to be retained *after* a loss to research for old policies. Now these professionals are part of the due diligence team. Policies dating from the 1950s and 1960s usually contain broad occurrence form provisions and may be a source of recourse.
- ***Sales contract.*** Sellers and buyers must be certain legal counsel has experience drafting merger/acquisition sales contracts. Both parties should insist on providing prompt notice and cooperating with each other and their insurance carriers in defense of lawsuits. Sellers should only agree (whenever possible) to indemnify the purchaser for losses occurring before the date of sale. Do not leave open extended indemnifications beyond the closing date.
- ***Insurance coverage.*** Policies are available that will cover "prior acts"; thus, it is vital to have a professional insurance broker on your team. To obtain these coverages, full disclosure is necessary; without it, coverage can be voided.

Mergers and acquisitions are more than price negotiation. Their success lies in the risk management process you employ to evaluate your exposures and transfer or otherwise minimize your risk. ■

Harry P. Mirijanian is president of Applied Risk, an independent risk management services firm created to assist the business community in reducing exposure to loss and insurance costs. He is a frequent speaker at AMA seminars.

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