Who’s at Risk When Corporations Split?

D&O Risk and Insurance Issues Involving Corporate Splits

By John M. Orr

Introduction

A new trend is emerging in the world of large public companies: splitting up to pursue more focused strategies. Hewlett-Packard, eBay, Agilent, and Symantec are all examples of organizations that recently announced splits into separate publicly traded companies. The antithesis of growth through acquisition or consolidation, the phenomenon of corporate splits has emerged as “the new thing to do in the Silicon Valley.” As with other large organizational transactions, corporate splits may yield opportunities. Opportunities, however, present risks. Risk itself raises a need for companies to evaluate their risk transfer and insurance program strategies. Companies considering a split or insurance brokers assisting them with the exploration of this idea should first consider the transactional and operational risk associated with splits, as well as related executive liability insurance concerns.

What’s Driving the Corporate Divide?

A combination of forces appears to be prompting the phenomenon of corporate splits. Investors have demonstrated an appetite in companies with more concentrated strategies. Units or divisions may be profitable in their own right. Over time, large companies may find themselves overseeing numerous, evolving business units with differing goals and strategies. Management may feel a lack of focus, having to address significant internal inefficiencies associated with the larger conglomerate.

Management and shareholders may also perceive split companies as more nimble and capable of competing on their own. They might observe advantages in these companies implementing their own growth strategies and adjusting to changing conditions in marketplaces that are unique to them.

Investors are both buying into this strategy and in some cases, driving it. The split of eBay and PayPal, for example, was motivated by activist shareholder Carl Icahn. Other activist shareholders, such as Nelson Peltz and Daniel S. Loeb, have pressured DuPont and Dow Chemical, respectively, to do the same thing, albeit without success to date.
Operational and Liability Risks that Accompany Corporate Splits

Challenges associated with splits include the risk that the newly created organization may not perform as expected. For example, HP’s new PC and printer entity, HP, Inc., will be facing an environment in which PC sales are down and newer market entrants, such as Acer, have seen success. As a consequence, the new HP, Inc. might experience lower than expected earnings that would no longer be offset by the more robust earnings of the HP enterprise products and services entity, to be known as Hewlett-Packard Enterprise.

Beyond operational risk are the regulatory and disclosure risks involved in the splitting process itself. Protocols associated with dividing a large company will entail splitting financials and dividing certain operations from other aspects of the organization where there may be overlap, such as joint research projects. Dividing intellectual property interests may become complicated in some cases. For public companies, risks also will involve public disclosures surrounding the transaction and heightened shareholder scrutiny. If there are inaccuracies in financial and risk disclosures, and drops in share value following corrective disclosures, ambitious plaintiffs’ attorneys may be quick to allege violation of securities laws in the issuance of false or misleading public statements.

Additionally, shareholders of the pre-split company often receive shares in both of the post-split companies. Similar to merger objection lawsuits, shareholders may challenge the methodology of the allocation and the ultimate value they received.

Protecting Directors and Officers During Corporate Splits

In consideration of these risks, companies should focus on structural issues with the Directors and Officers Insurance (D&O programs) of the pre-split and post-split companies. For instance, it will be important for companies to evaluate strategies to wall off pre-split and post-split exposures. To achieve this, the pre-split company would place its D&O program into runoff, also known as tail coverage. Runoff coverage ceases ongoing coverage for the pre-split entity, effective the split date. Coverage then continues for a period of years to capture claims that allege pre-split wrongful acts. At the same time, the post-split entities would secure their own ongoing D&O programs, covering them for the post-split acts of the new organization and their directors and officers.

Issues could also arise in the context of underwriting pre-split and post-split coverages. Major D&O markets participating in the programs of more than one of the companies may attempt to restrict their overall liability through “tie-in of limits” clauses. In this arrangement, even if an insurer has issued a policy to each of the post-split companies, the insurer might force language into both policies that limits its overall liability to a single policy limit. On the one hand, insurers prefer tie-in of limits clauses to prevent exposure to more than one limit for the same claim. On the other hand, insureds contend that the clauses are unfair, as the insurer takes in premium for multiple policies and potentially should be exposed to the full limits of each policy.

Regardless of how old and new D&O programs are structured, if significant litigation were to arise naming the pre-split company and one or more of the post-split entities, care should be taken to decipher under which program(s) coverage should reside. Coverage issues could include:
• Whether allegations are sufficiently related or unrelated, such that more than one policy may be implicated. This might be the case where pleadings are filed in different policy periods, or where existing pleadings are amended in subsequent policy periods with allegations that differ to some extent;

• Whether entity coverage for one of the companies is implicated if the shareholders of another company sue. This can be a concern because public companies maintain entity coverage under their D&O policies only for claims involving their own securities. Thus, if a post-split entity’s shareholders sue for alleged violation of securities laws, but also name the pre-split entity on an aiding and abetting theory, coverage under the pre-split entity’s runoff program may not trigger. In this respect, the claim would not appear to involve the purchase or sale of the pre-split entity’s own securities.

To mitigate against these and other possible coverage issues, companies and their brokers should scrutinize and, where necessary, negotiate language of key provisions of the D&O policy. Such provisions should include the following:

• **Change in Control:** The D&O policy automatically converts to runoff coverage effective the date there is a Change in Control, such as an acquisition of the insured or the sale of all or substantially all of the insured’s assets. Language in the policy may govern to what extent a split may trigger the provision. Insureds and their brokers should examine the Change in Control triggers and secure the insurer’s agreement to waive such provisions if doing so is consistent with program strategy.

• **Severability in the Application for Insurance:** A company’s financials are included as part of the D&O insurance application. The consequences of inaccuracies in the application may provide insurers with rights to rescind or limit coverage. With this in mind, it is important for the policy’s “severability” clause (which mitigates against such insurer actions as to “innocent” insureds) to be as protective as possible.

• **Personal Conduct Exclusions:** The exclusion for fraud or deliberate misconduct, as well as unlawful remuneration and personal profit, should include strong standards for triggering the exclusions. Companies and their brokers should explore specific language options in this regard.

• **Definition of Loss:** In cases where shareholders assert they were paid inadequate consideration for their stock in transactions, D&O policies typically exclude from the definition of “Loss” those sums constituting the inadequate consideration. Policies differ, however, in how broadly they word the exclusionary language relating to these claims. Accordingly, other forms of Loss, such as plaintiffs’ attorneys’ fees, may not be covered in claims challenging share valuation. For insureds that are acquisitive or potentially the subject of splits, attention should be drawn to the scope of these limitations.

• **Definition of Securities Claim as regards claims alleging aiding and abetting liability:** Policy language solutions may be available for companies facing this exposure.
Companies involved in splits also should evaluate the adequacy of D&O program limits for the post-split companies. In doing so, they should consider the possible heightened exposure surrounding the split itself. Additionally, they should assess limit adequacies in the context of actuarial risk modeling and insurance broker guidance and recommendations.

**Conclusion**

Corporate splits are an emerging phenomenon among companies across numerous industry sectors. While they present unique opportunities, they also present operational challenges, as well as risks associated with execution of strategy and public disclosures. As a consequence, companies and their brokers should evaluate the implications of splits on the D&O programs of the pre-split and post-split companies. With regulators, shareholders and plaintiffs’ attorneys looking on, the adequacy of D&O limits, program structure, and breadth of coverage are crucial elements to consider when contemplating a corporate split. The insight of an experienced insurance broker can give companies considering splits the critical edge they need to ensure all eventualities are examined in the pursuit of a possible split.

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