

# Proceed with Caution

by Joe Schaffner

## Caveat Emptor

Merger and Acquisition (M&A) activity is an integral part of any vibrant business market. No matter whether a Fortune 500 conglomerate announces the acquisition of its largest competitor in a hostile takeover or two middle-market companies merge to leverage resources in order to remain competitive—they inevitably face many of the same challenges.

There are many reasons an organization may choose to acquire or merge with another entity. Perhaps the company hopes to reduce costs, eliminate competition, expand market share or acquire new intellectual property. Whatever the reason, the business environment is rich with opportunities for potential mergers and acquisitions. This type of activity may be part of a company's long-term, strategic growth plan. However, even with thoughtful planning, many M&A transactions fail due to a lack of proper due diligence.

During 2006 there were an estimated 3,600 M&A deals negotiated globally, with a total net worth in excess of \$393 billion—an increase from 2004, which saw 2,046 deals valued at \$210 billion. (*"2007 M&A Outlook – Introduction," The 451 Group TechDealmaker, December 2006.*)

## Words of Wisdom

It's extremely important to address financial issues before finalizing any M&A transaction. Failure to plan may negatively affect risk management, group health insurance and human capital long after a deal is completed. According to the *Weekly Corporate Growth Report* from June 14, 2006, "70% of mergers fail to achieve their anticipated value." This is not because of a lack of vision or a strategic flaw in the process, but is usually due to circumstances beyond the purchaser's control. Unforeseen liabilities, inadequate safety and loss control or even unanticipated employee benefit costs can stymie revenue momentum and slowly undermine the value of the acquisition. These pitfalls can, however, be avoided by prudent planning.

History has shown that the greatest potential risks associated with buying or merging with another company are often left unaddressed until after the deal is completed, which can have disastrous consequences. Financial institutions, law firms, and accounting firms have traditionally been the main consultants for M&A transactions. It wasn't until recently that the insurance

industry began to help uncover potential liabilities—successor liabilities— that may be inherited through an acquisition. A successor liability claim can evolve in a myriad of ways. It is critical that companies develop a well-rounded plan for managing liabilities associated with mergers and acquisitions. See Exhibit 1

## Investment Protection

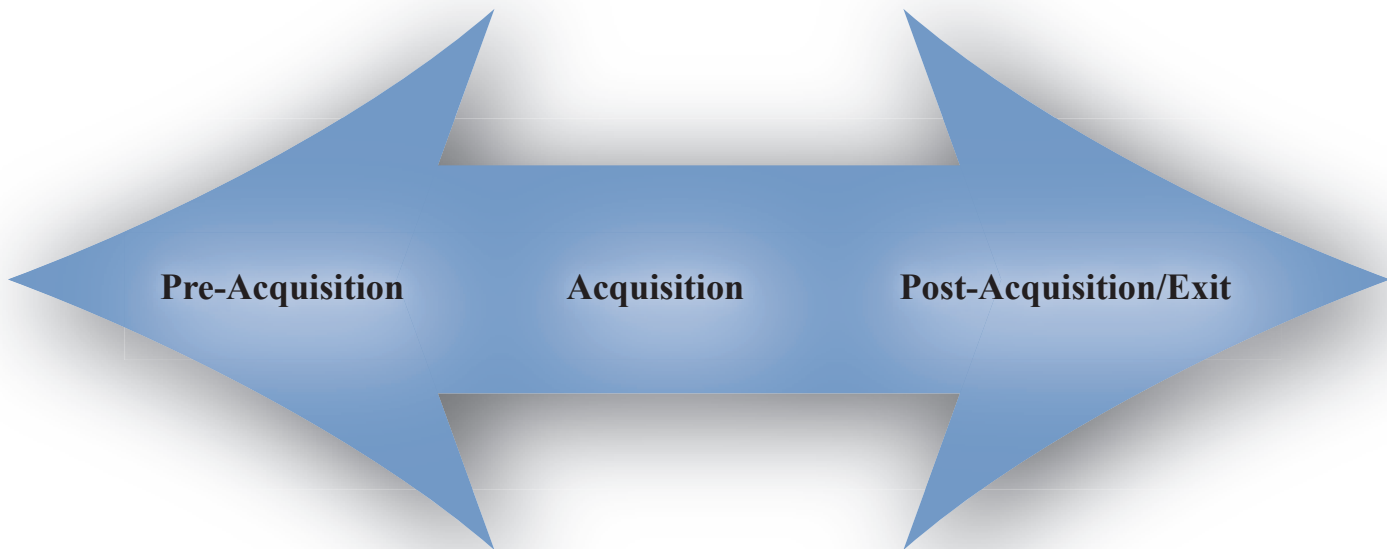
Even if an organization practices good pre-acquisition due diligence, there is a chance that some risk could remain. Acquirers have the opportunity to mitigate much unknown and unforeseen risk through insurance protection, providing monetary coverage for potential loss from future liabilities. The combination of pre-acquisition due diligence in concert with the appropriate insurance coverage may provide the most effective way to protect the acquiring company's assets.

It is not enough to simply assess the known liabilities facing a prospective deal. Under current U.S. law, environmental liabilities and product liabilities unknown to the seller or potential buyer may emerge years—and possibly even decades—after the transaction has been completed. It is also important to note that insurance assets are generally transferable from a purchased company to its purchaser.

A comprehensive insurance audit should assess not only the prospective partner's current insurance coverage, but also its long-term insurance history, including any and all information on previous mergers. At a minimum, a 10-year historical window is highly recommended. It is one thing to uncover a potential liability and another to know what to do with that information. Fortunately for prospective purchasers, there are protections against potential, and even unforeseen, liabilities. U.S. courts have traditionally held that the company deemed liable for a predecessor's liability is entitled to coverage under the predecessor's applicable insurance policy. In other words, **the transferability of insurance assets from seller to purchaser is essential in any deal.**

Given the broad transferability of insurance policies to corporate successors, along with the high value of old insurance policies, a comprehensive due diligence process can spell the difference between acquiring a dynamic gem-in-the-rough or an asset-draining lemon. Buyer beware!!

## Exhibit 1



### Due Diligence

- Assign dedicated project teams
- Strict confidentiality
- Understand operational/cultural profile of target
- Evaluate current and historical insurance & benefit programs
- Comparison of existing costs vs. pro forma estimated costs
- Project self-funded costs & cash flow implications
- Identify one-time transaction expenses
- Assess accrued insurance, benefit & pension liabilities
- Analyze/highlight program collateral requirements
- Uncover hidden liabilities
- Develop solutions to eliminate, fund or cap unforeseen risks
- Develop post-closing plan & integration strategy
- Pre-acquisition investment analysis
- Review financial solvency of present & past insurers
- Strategic input: industry due diligence/intelligence

### Structure & Implementation

- Help obtain favorable transaction terms
- Private placements
- Valuation & strategic assessment: Human Capital
- Help develop transaction communication strategy and services agreement, if necessary
- Placement of coverages with highly competitive terms
- Implementation of transactional risk solutions, e.g., rep & warranty coverage, environmental caps, Directors and Officers run-off coverage
- Implement go-forward plan integration strategy
- Provide documentation support to lenders

### Transition & Oversight of Programs

- Design and implement new programs as needed to fit business strategy
- Work with portfolio company to identify ongoing cost reduction opportunities
- Implement best practices
- Develop performance measures for plans
- Assimilate workforce into programs, policies and systems
- Fully implement communication process
- Ongoing employee and workplace consulting
- Strategic divestitures (M&A advisory)
- Performance monitoring