

Mergers and Acquisitions: Due Diligence Checklist

Whether your firm wants to buy, sell, or find another firm with which to merge, you first need to perform a thorough due diligence to be certain any deal will be a good one. As part of that due diligence, it's important not to forget risk management and insurance. Neglecting this piece of the puzzle can be a costly omission. In this article we address some of the key risk management and insurance issues that should be part of your decision-making process.

Legal Aspects of M&A

Two firms can become one in more than one way. There are three predominant approaches to knitting two organizations together.

The Three Predominant Approaches

One approach is for your firm to buy the assets of another firm. You can buy all or part of the assets. In so doing (at least in theory), you do not acquire the liabilities—pending claims, short- and long-term debts, and so on—of the other firm.

Another approach is for your firm to purchase the other firm outright. This is usually accomplished by purchasing the stock of the other firm. With this type of acquisition, you're buying everything, good and bad. The other firm's headaches become your headaches.

A third approach is a true merger. Your firm and the other firm disappear and are replaced by a newly created entity that comprises all the assets and liabilities of the predecessor firms.

Pros and Cons

In general, an asset purchase is better for the buyer—buying the good stuff and not the bad; a stock purchase is better for the seller—selling any problems to another firm along with the assets. On the other hand, selling only the assets might result in a higher price, benefiting the seller; buying the stock might make the buyer the preferred “suitor” if the seller has more than one offer.

Because each firm's objectives are different, whether the transaction ends up being assets-only or stock is based on a number of factors, including

how badly one firm wants to sell, how badly the other firm wants to buy, how much the assets are worth, how bad the liabilities are, and so on. In a perfect world, both parties will walk away pleased with the deal; in the real world, both parties will likely feel the deal wasn't quite fair—the buyer thinks the price was too high; the seller thinks the price was too low. Chances are if both sides are feeling slightly aggrieved, the deal was a fair one.

Insurance and Risk Management Due Diligence

The insurance and risk management due diligence is just as critical to the success and profitability of a merger or an acquisition as the other pieces of the M&A puzzle. In order for it to be a good deal—for the buyer *and* the seller or for the newly merged organization—there's a lot of information that needs to be shared and analyzed. At a bare minimum, you should start by gathering the following information:

- copies of all current and prior policies;
- claims histories/loss runs; and
- prior and pending litigation.

For smaller firms, you should go back at least five years; for larger firms, you should go back ten. And the information should include not just professional liability; it should include all property and casualty policies purchased.

For property claims in excess of \$25,000, you need the cause of the loss, the amount of the damage, the deductible assumed by the firm, and a

description of what has been done to prevent a recurrence.

For any closed liability claims in excess of \$25,000, you should ask for details—the allegations, the method of adjudication (alternative dispute resolution, trial, and so on), the defense costs, any settlement by the insurer, and the amount of loss retained by the firm. For any open liability claims, you should get details from the defense counsel and the insurer about the allegations and the estimated cost of defense and settlement.

In addition, you should obtain copies of all documentation of risk management philosophy and procedures, including (but not limited to):

- written risk management policies;
- policy and procedures manuals;
- recommendations from insurers;
- safety committee minutes; and
- any corrective actions recommended or mandated by governmental authority.

Claims-Made Policies

Professional liability insurance (PLI) policies are written on a claims-made basis. In other words, the claim is covered by the policy in effect when the claim is filed, not when the event or circumstance that gave rise to the claim took place.

When a firm is sold and no longer has ongoing operations, it generally stops buying PLI. But what, then, happens to claims filed after the expiration of the last policy? Without a current claims-made policy in effect, the seller and the buyer need to make provisions for such claims.

Solutions

The most common solution is to buy an extended reporting period (ERP), also known as a tail. Tail coverage is generally bought as an extension to the last claims-made policy issued to a firm that is sold, goes out of business, or otherwise determines not to buy PLI anymore. Common tail coverage periods are one year, two years, and three years. But the limit of insurance—the expiring amount—may not be enough. And in a tail policy, that limit covers the

entire duration of the ERP. Although most professional liability claims are likely to be filed within three years of substantial completion of a project, some are filed much later—sometimes, decades later.

Two of the factors that have a bearing on how long a tail to buy are statutes of limitations and statutes of repose:

- Statutes of limitations set forth the maximum amount of time after an event that legal proceedings may be initiated, but there are events that can extend that period. Statutes of limitations vary from one jurisdiction to the next.
- Statutes of repose are not as malleable as statutes of limitations can be. They set forth the maximum amount of time after completion of an act—such as a construction project—that legal proceedings can be initiated. The good news is that statutes of repose—because they are tied to an act, not to an injury—are more exact. The bad news is that in some states, the statutes of repose can provide upwards of 10 years of liability.

Some—but not all—insurance policies come with built-in options for purchasing an ERP. If you anticipate selling your firm in the near future, check your insurance policy to see what options are already in the policy. If there are no options or if the options do not meet your needs, ask that the appropriate options be added to your policy so that you will know, in advance of any price negotiations, how much it will cost you to purchase this protection.

Because of the cost of the tail policy, we recommend that the responsibility for its cost and purchase be negotiated early in the transaction—preferably, in the letter of intent.

Of course, buying a tail from your current insurer is not your only option. Other options include the following:

- **Runoff policy:** Unlike the ERP, for which the price is generally predetermined in accordance

with your PLI policy terms and conditions, a runoff policy is individually priced by the underwriter. The price may be better than the tail coverage under your PLI policy.

- **Retired professional policy:** This policy is similar to the runoff policy except that it is generally only available to retired individual professionals and smaller firms closing their doors, not to larger firms that sell assets to another firm.

It is important to remember that all of these options cover only claims arising out of negligent acts, errors, or omissions that occurred prior to the sale. Ongoing operations should be covered by the buyer's policy. Thus, if your firm is the buyer, you should have your insurer endorse your PLI policy to cover prior acts related to any ongoing projects you have purchased.

Types of Policies Involved

PLI policies are probably not the only claims-made policies that the two parties to the transaction may have purchased. The following is a list of some of the other insurance policies that may require tail coverage:

- directors and officers liability;
- employment practices liability;
- employee benefits liability; and
- fiduciary liability.

Depending on how many of these insurance policies the selling firm has in place, the costs can add up to more than the buyer and the seller anticipate.

Workers Compensation

The workers compensation loss history of the firm your firm buys or with which it merges has its own long tail, so to speak, through the calculation of your firm's experience modification, your mod. The details of the calculation are pretty complex, but the overall effect is to reward those firms with better experience with a credit and penalize those with poor experience with a debit.

The mod looks at payroll and losses starting four years and ending one year prior to the effective date of the mod. When you buy or merge with another firm, the mod combines your experience with the other firm's experience. Very roughly speaking, if your firm has, for example, a mod of 0.75 (a 25 percent credit) and acquires another firm in the same business of roughly the same size that has a mod of 1.45 (a 45 percent debit), the combined mod will likely be around the midpoint of 1.10 (a 10 percent debit) or higher.

A debit mod can affect your ability to bid certain jobs, as some project owners require all contractors, subcontractors, and consultants to have a mod no higher than 1.00. If you have acquired such a firm and now find yourself unable to bid certain jobs or work for certain clients, you can try explaining your way out from behind the eight ball. One part of the explanation is the loss experience since the acquisition. If you can demonstrate that your management of the acquisition has improved the frequency and severity of workers compensation claims, that might persuade some clients to continue using your services.

Remember, though, that the pre-acquisition experience of the other firm will be part of your mod for four years. If it's really poor experience, you'll be paying more for workers compensation and perhaps not landing certain projects for most or all of that time.

General Liability

Your firm's commercial general liability (CGL) insurance policy is most likely written on an occurrence basis. Coverage applies when the event triggering the claim occurs regardless of when the claim is filed. But the occurrence is defined as when the catwalk above the atrium collapses, not when you designed it. Some occurrences can happen years or even decades after your policy expires.

The seller should continue coverage by purchasing a policy to cover discontinued operations. Depending on circumstances—such as the statutes

of limitations and repose already discussed—the seller may want to purchase coverage for a number of years. Such policies are generally less expensive than covering ongoing operations. No new exposures to loss are being created, so the risks being insured are likely diminishing.

In the event that it's truly a merger, not an acquisition, it's important for the new entity to continue to insure the old entities. If AB Corporation merges with YZ Corporation to form MN Corporation, all of the policies for MN should continue to include AB and YZ as named insureds—not for the current operations, but for the current occurrences arising out of past operations.

Pricing the Transaction

If your firm is the buyer, when you get down to the process of pricing and paying for the transaction, many firms will employ either a two-year earn-out or an escrow fund to protect themselves against contingencies and expenses arising after the closing date. A common deal structure involves payment of 80 percent of the agreed value of the deal, holding back 20 percent for contingencies.

One insurance contingency that can be substantial is audits. Workers compensation, general liability, and sometimes other liability coverages are based on estimates of payroll, revenue, and similar measures of exposure to loss. If a premium is based on reasonable estimates, the audit should not result in much additional premium; but sometimes, the final premium is substantially higher than anticipated.

Other contingencies include loss-sensitive policies with premiums that can increase by 50 percent or more if the seller's firm has had adverse loss experience. And there's always the possibility that a seller's losses could blow through the aggregate on a liability policy, leaving your firm to pick up defense and claims costs you did not anticipate.

On the seller's side, even with the purchase of a tail policy, the seller will still be responsible for deductible payments.

Holding back some money for a couple of years can fund or at least mitigate the cost of these and other contingencies.

Human Resources and Corporate Culture

If all the numbers line up well, that doesn't necessarily mean that the merger or acquisition will succeed. Remember Time Warner and AOL? Briefly married; soon divorced. A whole lot of effort that ended up costing both sides—a lose-lose situation.

Look at safety policies, office rules, benefits, and overall attitude. If there's not some degree of commonality in the way each firm operates, the deal may still be a bad one.

And last, don't forget the people. All too many mergers and acquisitions fail because the people and the separate corporate cultures are never properly blended. A firm that involves itself in community service may not fit well with one that's a strictly for-profit business. A corporate culture that values creativity and excellence over volume may not be able to adapt to a firm that cranks it out like an assembly line. Firms whose employees routinely work until 6 p.m. or 7 p.m. every night may view employees accustomed to clocking out at 5 p.m. every day as slackers. After the deal is done on paper, you need to continue working on the deal in the office, proactively combining two separate work forces into one.

In Closing

A proper insurance and risk management due diligence is time-consuming, but it's time well-spent if it helps your firm avoid merging with the wrong firm, making the wrong acquisition, or overpaying for the right one. The time to find out the bad news is before you sign on the dotted line, not after.

To help you succeed with any mergers or acquisitions, we have prepared an insurance and risk management due diligence checklist. To obtain a copy of this checklist, please send an e-mail to info@greyling.com.

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