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ACE Progress ReportSM:

*M&A Risk Management:
Avoiding Pitfalls, Finding Solutions*

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M&A Risk Management: Avoiding Pitfalls, Finding Solutions

By Seth Gillston, SVP, ACE USA Mergers & Acquisitions Industry Practice

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Executive Summary

After several years of low activity, mergers and acquisitions are on the uptick. The volume of both private equity transactions and strategic deals has risen over the past six months, and analysts expect the revitalized M&A environment to continue through 2011.

There are several factors assisting the steep hike in M&A deals. Articles in the business press point to a significant rise in CEO confidence and easing of lending terms as promoting renewed interest in mergers and acquisitions. Having hunkered down and hoarded cash during the recession, companies now seek to invest some of this capital in strategic M&A growth objectives.

Nevertheless, while M&A activity appears to be returning to historical norms, the regulatory and legal landscape has dramatically changed, there is greater potential for unseen or under-appreciated risks that can otherwise doom a sound merger or

acquisition. In the aggressive timelines to close transactions, due diligence often is compressed and compromised, heightening the potential of not fully identifying the target company's historical and ongoing liabilities. These include known and unknown legal, regulatory, environmental, casualty, and management liabilities, among other prospective and retrospective exposures.

This white paper is a roadmap to guide private equity firms and corporate M&A dealmakers through the M&A risk identification process and present insurance solutions to mitigate the exposures. This report makes the case for a coordinated approach to managing the successor risks and liabilities of a merger, acquisition or divestiture as a best practice. It further maintains that only a few insurance companies have the skills to coordinate and respond to the insurance components of M&A risk management for private equity firms and corporations.

Section One: Successor Casualty Liability: How long is the tail?

Following a merger or acquisition, the buyer—a company or private equity firm—typically absorbs the liabilities of the acquired entity. If a company has acquired numerous organizations through the years, some of which may no longer exist, these successor liabilities can be daunting from a risk management standpoint. Making matters especially problematic is that the acquired company's insurance policies generally either cease to provide coverage, or convert into run-off mode, essentially providing coverage for a short period of time. The adequacy of these insurance policies in terms of absorbing prospective and retrospective financial losses also comes into play. If these successor liabilities are not identified, assessed, and mitigated, they can create latent issues for the acquirer. They also may create surprises that were not accounted for in the purchase and sale agreement.



Loss Portfolio Transfers

Understanding the self-insured/deductible obligations, accruals and collateral requirements of the target company is essential. Are there any allocation issues where separate companies will now share the same historical policy? Acquirers should consider retaining an independent actuarial firm to assess the workers' compensation, general and automobile liabilities. If desired, retroactive limits of liability may be provided in order to bolster the financial protection afforded by the target company's insurance policies. This may include a loss portfolio transfer (LPT)—a retroactive insurance program transferring uncertain future payment obligations, related to past known liabilities from discontinued businesses or current operations, to the specialized M&A insurer. For instance, an LPT can be structured to absorb the financial liabilities of the deductible within the target company's insurance policies. For casualty claims in the primary layer, an LPT is considered especially ideal.

Insureds that have multiple captives post acquisition or are looking to exit self-insurance will find benefits in a loss portfolio transfer. The LPT can be used as a mechanism to close out the captive(s) or exit self-insurance for the retroactive liabilities. An LPT is essential to reducing burdensome collateral requirements/costs following a merger or acquisition, where the target company's financials may have altered.

While M&A activity appears to be returning to historical norms, the regulatory and legal landscape has changed. There is a greater potential for unseen or under-appreciated risks.

Umbrella and Excess Liability

There are other risk transfer solutions addressing M&A-related liabilities, such as umbrella and excess casualty insurance. High financial limits of protection can come in to play as umbrella insurance attaching above the primary layer of coverage, or as excess insurance attaching at different layers in a tower above the umbrella.

Questions often abound about future liabilities arising from the target company's products currently in the stream of commerce, or from products that were discontinued years before, but still pose potential liabilities. Among these questions are:



- Will the target company's product liability insurance address these future liabilities?
- Do gaps exist in this insurance coverage?
- Are there exclusions that may open the acquirer to possible liability?
- Do the terms and conditions of the contract permit the insurer to rescind coverage or deny a claim for late notice?
- Are the financial limits sufficient to absorb the extent of potential losses?
- Is the insurance policy with a financially sound insurance carrier—one that will be solvent in the future to pay any claims?

If the answer to any of these questions is "No," it raises the distinct possibility of financial loss for the acquirer. If these financial exposures are not well understood and addressed in the pre-transaction phase, the acquirer may incur additional costs down the line, rendering the transaction price higher than it should have been.

There are other risk considerations in an M&A context. For example, some insurance policies in the past were underwritten on a so-called "claims-made" basis. This form of insurance involves coverage that limits liability for only those claims that arise from incidents that occur and are reported to the insurance company while the policy is in force. This raises the possibility of a future claim for a prior incident the policy may not absorb, particularly if the claim's "tail" was not resolved adequately.

These concerns necessitate partnering with a specialized M&A insurance carrier. Such companies can provide unique risk transfer solutions, such as loss portfolio transfers, legacy liability insurance, controlled master programs and other casualty insurance products. These insurance policies can provide peace of mind regarding lingering liability concerns, by absorbing both known and/or unknown liabilities.

Legacy Liability Issues

Legacy liability insurance is a broad risk transfer solution absorbing successor liabilities for both retrospective and prospective claims arising from prior acts by the target company. A legacy liability policy is especially effective for severity-related product liability and general liability claims in the primary or excess layers. The risk of future claims from discontinued products is addressed, and laser-like coverages, for specific products that may pose a greater risk of potential hazard, are also available.

Legacy liability insurance can be acquired with a claims-made conversion trigger, in which the target company's claims-made policies are converted to standard "occurrence" forms, which absorb any claims brought against the insured, regardless of the time limit for reporting the claim. Above all, the insurance bridges any gaps that may exist in the target company's insurance policies that could invite financial losses for the acquirer in the future. The policy duration can be from one to five years, based on the client's discretion, and the insurance can be customized to address foreign M&A transactions.

Global Casualty Issues

With regard to inherited liabilities from global mergers and acquisitions, acquirers may want a Controlled Master Program (CMP). This type of insurance addresses the potential inadequacies of the target company's local or admitted insurance policies issued. Are there certain international exclusions in the current program that need to be addressed? The master insurance policy closes perceived gaps in coverages and/or financial limits, while simultaneously maintaining the local insurance policies in force. This may provide tax benefits, since locally paid premiums and insured losses are often tax deductible. A CMP also assures the efficient coordination of foreign insurance policies under one roof, with potential premium savings and additional cost-effectiveness from economies of scale.

Both known and unknown successor liabilities lurk in overseas M&A transactions. The legal due diligence, however, is compounded by language and cultural barriers. The use of claims-made policies and the risk of discontinued products cropping up to cause future losses can seem daunting to acquirers. Many countries also require the purchase of local or "admitted" insurance, raising questions over the adequacy of the coverages and the financial limits of protection, not to mention the solvency of the insurer that wrote the policy.

Transactional Insurance Products

Two additional insurance products that may prove beneficial in an M&A context are Representations and Warranties insurance and Tax Indemnity coverage. Oftentimes, these products are required in the Purchase and Sale agreement. Such insurance, for example, will indemnify the acquirer when the seller's representations and warranties prove inaccurate down the line. Examples involve representations and warranties made around compliance with local regulations or the seller's inventory.

Tax Indemnity insurance can be used to indemnify the insured for uncertain tax consequences related to the target company including the tax treatment of the M&A transaction itself. This product is considered effective when the buyer has not procured (or could not procure) a Private Letter Ruling from the Internal Revenue Service as to the tax treatment of the acquisition, but there is a need to obtain such protection.

Pre-Closing Processes

M&A dealmakers are encouraged to consider the following processes prior to closing a transaction:

- Did you form your deal team and checklist?
- How is your team positioned to address insurance items in the Purchase and Sale Agreement?
- Are there potential liabilities that will affect the overall purchase price or items that are delaying the transaction?
- Do your insurance partners understand the broader relationship?
- Have you considered the following insurance solutions?
 - Loss Portfolio Transfers to mitigate contentious collateral or indemnity issues and protect against potential adverse loss development
 - Legacy Liability Insurance to provide adequate excess casualty/umbrella limits
 - Representation & Warranty policy that may make the prospective buyer's bid more competitive
 - Environmental remediation cost cap coverage that can address latent exposure
 - Run-off D&O program that has consistent coverage to protect the board

Section Two: Environmental Liability: What lies beneath?

Currently, all businesses, no matter where they operate, confront ever-stricter environmental regulations, and thus greater liability exposures. In some cases, the acquiring company will inherit the target's pollution exposures, going back many decades, via the target company's previous mergers and acquisitions. These liabilities may be unknown at the time of the M&A transaction. They may also be the result of previously unregulated practices that have since been deemed illegal. In either case, these successor liabilities challenge the most thorough due diligence, and present the risk of tremendous financial liabilities. Indeed, few issues have the potential to derail a deal more from a liability standpoint.

Environmental liabilities encompass a broad range of perils, including pollution, contamination, mold, hazardous waste, and toxic chemicals in water, air or on land. Identifying these exposures and then assembling an effective insurance strategy to transfer the liabilities is a vital element of the M&A transaction process.

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Proper due diligence in investigating the target company's environmental liabilities must take into account the changing legal and regulatory landscape around the world. The United States was the first country to implement strict liability regimes for pollution, enacting the Clean Air Act in 1970, followed by the Clean Water Act two years later. Other laws include the 1976 Resource Conservation and Recovery Act, and the 1980 Superfund law, promulgated after the Love Canal toxic waste disaster.

Foreign countries have embraced the principles underlying these laws for their own purposes, leading to stiffer environmental regulations virtually worldwide. Recently, the European Union (EU) enacted a new Environmental Liability Directive affecting all 27 of its member countries. The directive goes further than previous laws, by recognizing a new class of pollutants—genetically modified organisms that are released into the larger environment.

Environmental Insurance Products

To fill the coverage void created by pollution exclusions in general liability products and protect against the financial exposure of pollution losses, the insurance industry created environmental impairment liability insurance. In this arena, various products are available to provide protection for the high costs associated with cleaning up accidental spills or leaks of pollutants. In circumstances in which the target entity had facilities that generated or used hazardous substances, Premises Pollution Liability (PPL) insurance should be considered. It provides coverage for first-party liabilities for on-site and off-site environmental cleanup and remediation, and third-party liabilities arising from lawsuits brought by others for bodily injury, property damage or environmental cleanup. The liability protection afforded by PPL coverage can be tailored to the needs of the acquiring company, including exposures related to sudden and accidental, or gradual pollution.

Since a target company's environmental liability policies typically will expire following the close of the M&A transaction, or be placed in a runoff mode, it is imperative for acquirers to address these voids with new policies before the deal is closed. There are other risk considerations that acquiring companies must address, such as the possibility of cost overruns incurred during a pollution cleanup. Specialized M&A insurance carriers can provide this through Risk Remediation Cost Containment insurance. By minimizing the risks of a cleanup project costing more than anticipated, the coverage mitigates the financial uncertainty associated with acquiring a site and undertaking its redevelopment.

Section Three: Directors and Officers Liability: Will you have adequate coverage?

Securities class actions represent some of the most costly and complex cases against directors and officers, and M&A activity is a key driver of securities class actions. In 2010, there were 40 securities class actions relating to mergers and acquisitions, in contrast to only nine in 2009.¹ 2011 may see more increases in these cases, given the continued rise in M&A activity. D&O insurance provides critical protection to executives sued in these cases. These class actions are filed very quickly after a merger or acquisition, not leaving much time to manage insurance issues.

Directors' and officers' liability insurance policies (D&O policies) can provide key protection for executives embroiled in M&A litigation. However, coverage must be in place and carefully managed prior to the transaction, in view of the speed and complexity of the litigation.

D&O policies are claims made and reported policies, meaning they cover only claims first made and reported during the policy period. If the policy period or any extended reporting period ends, so, too, does the ability to report a claim or potential claim. Timely notice is even more of an issue in a merger and acquisition, because most D&O policies provide that a policy will automatically terminate if more than a stated amount of assets are sold, or if another person or company acquires the right to appoint more than a stated number of directors on the board. The policy stays in place until the end of the policy period, but only for reporting claims arising out of acts that took place prior to the acquisition. Hence it is critical to be aware of policy term changes and notice requirements in the context of mergers and acquisitions.

Most D&O policies have terms of one year, yet many claims may be brought as long as six years after a transaction depending on the statute of limitations. As a result, most target companies purchase a non-cancellable, pre-paid policy for a six-year period, which is known as run-off or tail coverage. It can be critical. Most acquiring company policies will not provide coverage for directors and officers in their capacity as an executive of the target company prior to the merger or acquisition. As such, the target company's policy and run off policy may be all that they have to protect them. Because of this, many companies will also buy an additional layer of insurance devoted to the directors and officers, popularly known as Side A, or CODA, insurance.

Directors and officers of the target company will need to become protected under the acquiring company's own D&O policy if they become executives of the acquiring company. The former target company policy will provide coverage only for acts in their capacity as executives of the target company. The acquirer policy is needed to provide coverage for forward-moving acts in their capacity as executives of the acquirer. However, whether and to what extent they are added to coverage depends on the form and the facts. It is important to review the acquiring company policy to see whether they will be automatically added to coverage, or whether specific acts must be taken to add them to the policy.

The key to addressing D&O liabilities in an M&A context is to leave no ambiguities on the table. Post-transaction, the risk profile of the combined entity has changed, in some cases substantially. The threat of share price volatility in the months after a transaction closes typically is higher, possibly inciting shareholder or acquirer lawsuits against directors and officers for misrepresentations,

breaches of fiduciary duties or violations of the securities laws. This enhanced financial exposure argues for accessing the services provided by an experienced D&O insurer.

Conclusion – How to stay relevant during the process?

Now that the M&A market is on the uptick, private equity firms and strategic corporate dealmakers—in the competitive landscape to complete deals quickly—must exercise proper due diligence given the wide range of post-transaction successor liabilities they may assume. Such liabilities create the potential of unanticipated financial consequences that, left unheeded, may result in an acquisition or merger that costs more than is warranted, possibly inciting shareholder litigation. Risk managers should suggest assembling a deal team to review such potential liabilities.

The complexity inherent in addressing a target company's D&O liabilities, environmental exposures, product risks, and other complex liabilities requires assistance from insurance carriers who understand the M&A process and are specialists in related insurance solutions. Such carriers have a one-stop approach to insuring M&A risks and liabilities. They offer the required responsiveness to facilitate the closing of transactions within set timetables—minimizing the possibility of the emergence of unexpected and uninsured post-transaction liabilities.

The ACE Solution

ACE USA's Mergers & Acquisitions practice is focused on helping brokers and their clients identify the casualty, environmental, property, and management liability challenges inherent in their M&A activities and providing a range of insurance and other unique risk transfer solutions. ACE sees its role as a strategic partner for its clients and, as a result, this approach helps mitigate contentious claims or service issues. The company's M&A practice concentrates both on strategic mergers and acquisitions and private equity deals. It provides insurance solutions and manages the relationship between the private equity firm, ACE and their portfolio companies. For example, a portfolio approach may be optimal in the areas of property, accident & health (A&H) and management liability to create economies of scale and greater purchasing power.

The portfolio approach also applies to the claims administration. By combining insurance programs from disparate insurance carriers and/or claims administrators after a merger or acquisition, greater synergies can be realized through the use of a single third party claims administrator (TPA), particularly

one with expertise and a substantial geographic footprint. ESIS® part of the ACE Group, works with clients to analyze their claim histories and trends using sophisticated data analytic approaches that help pinpoint cost drivers and recommend strategies that can help avoid or mitigate losses.

Within the M&A practice is a team of risk management, claims, legal and insurance specialists who work together to help clients navigate the uncertain M&A landscape. This coordinated delivery of M&A insurance solutions is underwritten by an insurance carrier with unquestioned financial strength and stability, yet another reason to consider ACE.



Post-Closing Processes

Now that the M&A transaction has closed, buyers are encouraged to consider the following:

- Program Structure: Do the retentions under the combined insurance program suit the risk appetite of the newly formed company?
- Collateral: If the newly emerged company has a higher collateral cost, what options are there to consider under the current primary casualty program? Alternative collateral products and/or first dollar programs.
- New claims management approach to address multiple TPAs and or shared historical insurance programs across entities.
- Has your international footprint changed where you require an efficient multinational program address your foreign policies?
- Are you coordinating or aggregating your insurance procurement with your Private Equity partners and/or related portfolio companies?

Only a few insurance companies have the breadth of skills to coordinate and respond to the insurance components of M&A risk management for private equity firms, as well as having the unquestioned financial strength and security to be there when claims occur.

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¹ Cornerstone, Securities Class Action Filings, 2010 Year in Review ("Cornerstone"), pp. 2, 33.



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