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RISK MANAGEMENT
MERGER AND ACQUISITION CHECKLIST

Before acquisition is considered:

- Establish policy statement when risk manager should become involved and functions to be performed.

- Establish a management directive or a checklist which can be used by acquisition team.

Phase I (Before any papers are signed)

A. Items to consider:

1. Review coverages in effect.

2. Where products are involved, identify product lines, including old and discontinued products that may give rise to claims. Review old annual reports, 10Ks, and other documents.

3. Evaluate exposure to product liability claims under successor liability rules. Assess ways of minimizing exposures.

4. Evaluate loss experience. Determine impact on future premium costs. Pay particular attention to products, workers' compensation, and professional liability claims that could have long payout periods. Review reserves to see if "sleepers" exist which could result in major judgments. Estimate an IBNR figure.

5. Verify open claims for sufficiency of coverage and evaluation of deductibles or SIR's.

6. What are total insurance costs? Will they be higher or lower after acquisition?

7. Evaluate exposure to asbestos and pollution claims, including claims that may arise from discontinued operations. Assess methods of minimizing exposures.

B. Elements to be incorporated into merger agreement:

1. Assign responsibility to the acquiring or to-be acquired firm during the interim period for damage or loss of property being conveyed, or for claims arising out of the acquisition.

2. Require that the acquired firm keep all insurance policies in force until notified otherwise.

3. Stipulate that a broad-form named insured clause be added for the newly merged or acquired entities.

4. Specify that any insurance policies of the acquired firm that come up for renewal during the interim period will be reviewed by the acquiring company before renewal.

5. If the acquisition is by purchase of assets, specify that the insurance policies of the selling company are not a part of the assets to be purchased. The acquired company does not immediately cease to exist. It lives until all assets have been distributed and dissolution is accomplished. It continues to have employees, and can be sued even if it has no other assets than proceeds of sale. Even after dissolution, distributed assets can be legally attached for some period of time.

6. If continuation of insurance is desired, i.e., property or auto, contact the broker or carrier and have new policies issued effective at the time of the transfer of title of the assets. All cancellations, audits, etc., relating to the policies owned by the selling company then become the responsibility of the seller rather than the buyer.

7. Stipulate, if possible, that the seller continue liability insurance for a number of years after the date of sale, particularly if claim-sensitive products are involved. It is not unusual to require the selling company to continue coverage in force beyond the date of sale in order to cover any occurrences relating to products manufactured prior to a merger. WATCH OUT FOR CLAIMS MADE POLICIES!

8. Avoid coverage gaps by providing special wording in the purchase contract so that the acquiring firm has the benefit of the acquired company's insurance. This is crucial for any claims based on occurrences prior to the date of acquisition -- it is highly unlikely that the liability carrier of the acquiring company would cover such claims. With recent successor liability decisions, this is becoming more and more important.

9. Assign respective responsibilities for liability that may arise or be discovered after the signing of the contract (inadequate insurance, retroactive coverage, product recall, etc.).

Phase II (Time between signing acquisition agreement and actual effective date)

If key individuals involved, key person life and disability coverages may be needed. Customer lists or other valuable documents may need protection. All valuable items identified, including insurance documents, should be protected.

A. PHYSICAL DAMAGE

1. Obtain a complete schedule of property values including aircraft, watercraft, automobiles showing owned, leased, and property in custody for which the firm is responsible. Schedules may show book or actual cash value, while you may want to insure some for replacement cost.

2. Identify critical equipment and determine positive ownership of large power transformers and other major equipment.

3. Use a flow chart to analyze consequential loss exposures and pinpoint extensive business interruption potentials.

B. WORKERS COMPENSATION

1. Coverage considerations

a. For various reasons, Risk Manager will want to review the W.C. insurer of a new entity ASAP prior to the merger. Items to be included in this study include:

i Coverage is applicable only in states listed on declarations page of policy. If acquiring firm's policy will become effective on the new firm when acquisition is complete, this must be modified.

ii An all states endorsement will temporarily remedy the problem in (i) but will not cover operations in monopolistic states.

iii Certain classes of employees may not come under W.C. laws of a particular state or may have too few employees in a state to come under compensation statutes. This can be remedied with a Voluntary Compensation endorsement written to cover all employees.

iv Look into need for USL&H, maritime, foreign comp, Jones Act, etc. coverage.

2. Cost Considerations

Should Workers' Compensation insurance after a merger & acquisition be combined? A possible exchange of employees -- or interchange of employees -- between parent and subsidiary may suggest the desirability of a single insurer. In the final analysis, decision as to what to do with compensation insurance after a merger or acquisition will be influenced primarily by cost considerations.

3. Experience Modification

a. Background: Rules that apply to various combinations of entities for experience rating purposes:

i If same person, group of persons, or corporation owns a majority interest in more than one entity, the entities must be combined for rating purposes.

ii firm acquires ownership of second firm, experience modification of parent becomes applicable to the subsidiary as of the effective date of the takeover and prior experience of the subsidiary is discarded.

iii If two or more entities are merged so that ownership interests of all such entities are combined in the surviving entity, the incurred experience of all such merged entities must be used for experience rating of the surviving entity.

i.e., How rules can work for or against:

Firm A, Exp. Mod 1.20
Firm B, Exp. Mod .85

Firm A buys firm B, If B's manual premium is $300,000 and "rules" applied, Firm B's premium increases $105,000.

To get around this, B could go self-insured or elect a retro rating plan.

Rules can also be reversed and work to your advantage.

b. Analyze Experience Modification

i Experience modifications should not be taken for granted. A thorough review of the worksheet and loss information can provide valuable information.

ii Substantial debit may indicate inadequate facilities, overcrowding, inadequate working capital, substandard labor, or laxity of management may be a contributing factor. If deficiencies can be overcome, proposed acquisition may be even more attractive. Otherwise, this should be recognized prior to the purchase.

iii Experience debit may also be the result of a misclassification for rating purposes or no classification that accurately fits the operation. Debit may have been caused by a few major accidents -- or a lot of minor accidents.

iv Remember, frequency of losses is often of greater significance than severity when analyzing the experience of any company. Implementation of loss control measures can very often reduce frequency problems.

v Debit could also indicate deficiencies in an insurance company's safety or claim service -- or both. If company coverage is combined, make sure that one insurer you select has the capability of providing the services you will need in the territories in which you operate.

vi May expect an increase in W.C. claims if workers anticipate the closing of a plant.

C. GENERAL LIABILITY

1. Well structured program should not create any problems during merger or acquisition. Well structured program means:

a. GCL policy

b. Broadened to eliminate many troublesome exclusions of "standard" coverage.

c. Reasonable limits of liability capped with Umbrella policy.

d. Written to cover new or additional entities.

2. Recommended that the Named Insured wording on policy be broadened to include language such as this:

   " . . . and all subsidiary, affiliated, associated, or allied companies, corporations, firms, or organizations, as now or hereafter constituted for which the Named Insured has the responsibility of placing insurance and for which coverage is not otherwise specifically provided."

3. Corporate counsel should be consulted as to the exact language to be incorporated in the Named. Insured wording. It should bring any new acquisition under your CGL automatically.

   If acquired company(ies) keeps separate liability policy(ies), parent should be included as Named Insured as relates to the activities of the affiliate.

4. Umbrella Policies

   a. Named Insured wording should be broad enough to cover newly acquired entities (similar to G.L. wording).

   b. Make certain that underlying limits of newly acquired company's policies are consistent with that of parent.

5. Consolidate Coverage?

   a. Evaluate service of parent's insurer -- Are they equipped to handle necessary claims service at all locations where operations of new firm conducted? Does it have experience in dealing with operations of the new firm? Does it have capability to handle the expanded operations to which the merger or acquisition may lead?

6. Deductibles

   Deductibles for one firm may be appropriate while for others totally unsuitable.

7. Allocating Premium Costs

   If necessary and a potential problem, separate programs may be best.

8. Review All Contracts

As soon as you can, you may want to review with counsel, all leases and other contracts into which the new acquisition has entered. You will want to know to what extent the acquired firm has assumed liability through hold harmless agreements, ... etc.

Want some type of program set up which requires subsidiaries and affiliates to file with the parent evidence of any assumed liability.

9. Imputed and Assumed Liability

Be aware when dealing with insurers to differentiate between imputed and assumed liability.

If liabilities are imputed to the buying company, then the prior insurers of the selling company should still provide coverage without the need for an accepted assignment of interest in those prior policies.

However, if the prior liabilities of the selling company are assumed by the buying company, then it is probable that the prior insurance of the selling company will not be available to the buying company without an assignment of interest agreed to by the prior insurers.

10. Pollution Liability

Will want to evaluate past and potential liability from this exposure if applicable.

If premiums based on gross sales, make sure that inter-company sales are excluded especially if acquired company is supplier of a key item in your finished product.

D. D&O LIABILITY

1. If policy in force, should be reviewed to determine policy provisions concerning addition of new positions, ... additional D&O's ... new entities, etc.

2. Have to familiarize new D & O's of do's and don't's regarding policy exclusions, company bylaws, and their responsibilities. If acquired company has D&O policy, policy may have to be cancelled -- Some insurers won't assign policies.

E. CRIME

1. Be certain that no lapse in fidelity coverage develops, otherwise coverage for all previous occurrences beyond the discovery period of the old bond becomes void. Also be sure that any new fidelity policy will pick up prior losses.

   Crime packages under which most Fidelity coverage is written do provide automatic coverage for 30 days.

2. Determine whether any payrolls are made by cash or if any substantial money or security exposures exist.

   Find out what the maximum cash is on the premises at any one time. Some firms keep as much as $10,000 petty cash on the premises at all times.

3. Other property? Securities, stamps, merchandise. New firm may have raw stock or finished goods particularly vulnerable to theft, i.e., electrical products, portable products with high value, precious metals, etc.

   Don't assume that insurance for the merged/acquired company was designed to cover them. Your own insurance may simply not be broad enough to handle these new hazards.

   Review crime insurance with the needs of the new entity in mind.

4. Check whether the firm employs persons who are not defined as employees in the fidelity bond. If so, they should be included in the acquiring firm's bond. This does not preclude the possibility that the acquired firm's bond may be better and be continued instead. Eventually, all employees should be brought under one bond.

   New affiliate may have business relationships with individuals <u>not</u> classified as employees (such as brokers, factors, commission merchants, consignees, contractors, or other agents or representatives) who would be close enough to the operation to cause serious loss.

   Solution: Ask affiliate's insurer to extend coverage to these people or have them or employers provide you with a bond.

   <u>Terminated Employees</u> -- As a result of a merger or acquisition, some employees may be terminated.

   Find out if your employees or those of new subsidiary covered while in

your "regular service" and for "30 days thereafter". Should try to extend to 60 or 90 days.

Look for evidence of prior fraud on the part of an employee. The parent's bond may limit coverage, particularly if an officer of the acquired firm had prior knowledge of the incident and the bond underwriter agreed to continue coverage. The parent's bond would not normally provide coverage for prior fraud.

Carefully review security procedures and loss control.

F. SUCCESSOR LIABILITY

1. Background: A defunct firm's liability used to be limited, but this is changing. Today, a company may be held liable for the products of a firm acquired twenty or thirty years ago and long defunct.

   Most states have specific common law rules on successor liability; these rules are broadening on a case-by-case basis

2. Steps to take: Weigh products liability exposure of the acquired firm in light of recent court decisions. If exposure exits, consider the following action:

   a. Change the product as well as personnel and management of the acquired firm, and if possible, the physical location.

   b. Buy assets rather than company stock and dissolve the firm.

   c. Contractually express refusal of accepting liability for the acquired firm's previous deeds in order to avoid implied acceptance.

   d. Make it clear to everyone that the old firm no longer exists, and that you do not provide services for the predecessor's products. Do not take over existing service contracts.

   e. Add an indemnification clause to the contract of purchase that the acquiring firm will be held harmless.

   The need for and availability of successor liability insurance should be determined. Such insurance will not avoid liability but it will help defray legal and claims costs if liability were imposed. Take care that such a policy expressly covers liability for the defunct firm's products without limitation as to the date of manufacture.

G. HISTORICAL DOCUMENTS

1. Provide safekeeping for all important documents as respects the transaction.

   Also need employee records, lab testing, Q.C records, old contracts (especially insurance contracts as far back as possible)

H. AGENCY/BROKER RELATIONSHIP

Long standing, favorable agent/broker relationships may exist which might be continued. Assess broker competency.

I. RISK MANAGEMENT STAFF

Review existing staff to see how they can be incorporated into surviving organization. Familiarity with local scene may often prove useful.

Corporate risk management manuals should be reviewed so they agree in Risk Management philosophy.

J. RETENTION PROGRAMS

Reserves on self-insured programs need special attention because of potential liability and tax implications. If firm has captive, special analysis of function and potential is essential.

Phase III (After Merger is Completed)

A. After the merger is accomplished, financial priorities may have shifted, working capital may be strained, and therefore, levels of self-assumption of risk may need to be lowered. On the other hand, the larger financial structure may call for higher retentions.

B. Accumulation of values may need reevaluation, as do the extra expense and business interruption exposures, particularly, if a close interdependence of operations between the acquired and acquiring firm is expected.

C. Policies may need to be brought back into the risk manager's file so that he or she is prepared for divestitures and spin-offs. Some of the subsidiaries or plants of the

acquired firms may not fit into the corporate plan, and, by being spun off, ease the corporate debt burden.

D. Final success from the standpoint of the risk manager means the following:

1. A well conceived and effective program of communications to assure smooth cooperation between the risk manager and the personnel of the acquired firm. The basis will be a redrawn corporate policy and risk management manual.

2. Appropriate and well understood claims procedures.

3. Active liaison between the acquiring firm's brokers and insurance carriers and the acquired firm.

4. A great deal of tact to achieve active cooperation rather than resigned acceptance throughout all phases of the acquisition period.