Protect against merger risk

Takeovers and mergers create plenty of uncertainties and new risks for companies and their management. Insurance can help smooth the way and provide comfort for deal makers. By Lee Coppack

The level of corporate deals contracted quickly when financial markets floundered in the summer of 2007. Yet, with companies looking for cost savings and opportunistic acquisitions, deals are expected to pick up as liquidity returns to the financial markets. Given the current volatility, there are more uncertainties than usual relating to the assets and liabilities of target businesses, so insurance has a role to play.

Buying a company is like most other purchases, according to David Shasha, a Partner in solicitors Simmons and Simmons, the basic principle is caveat emptor, let the buyer beware. It's up to the buyer to mitigate risk through contractual risk allocation arrangements, the sale and purchase agreement, and through due diligence and investigation of the target.

Warranties and indemnities

The buyer needs to know as much as possible about the target before agreeing terms, so when the transaction is amicable, the buyer will perform due diligence. However, even where a deal is friendly, there may be liabilities that affect the risk/reward calculation. "One of the functions of financial due diligence is to identify balance sheet exposure to hidden or uncertain liabilities that aren't fully accounted for," Damian Guly, a Partner in PwC Transaction Services, explains. "This would include such things as defined benefit pension schemes where the numbers can be very large."

Aside from adjusting the price, the buyer can seek protection from nasty surprises – holding back part of the purchase cost, or seeking warranties and indemnities. Warranties allow the purchaser to claim for damages if statements prove untrue, while indemnities reimburse the purchaser if a loss occurs in certain circumstances. These typically cover things like tax liabilities, environmental liabilities and specific outstanding issues, such as litigation.

Genie in the bottle

Such promises are only as secure as the person or company giving them. Three years later, the vendor may not have the means to meet the indemnities it gave, and recovering damages for breach of warranty could be uneconomic if the proceeds of the sale have been converted into a super-yacht. In hostile deals, and private equity or administrator sales, no warranties and indemnities may be available.

Insurance is the genie, waiting in the bottle until it is needed, and either side may use it to make the deal more attractive. Shasha says there are a number of situations where insurance is valuable: where the seller isn't giving any warranties or indemnities, the buyer is concerned over the seller's

ISTOCK PHOTOS

MERGERS: THE VITAL STATISTICS

Global **M&A volume was down 35 per cent** in the first six months of 2009, and the number of deals by 24 per cent. Bankruptcy and distressed M&A volume, however, was the second highest on record, exceeded only by the previous six months, according to the Dealogic M&A Review for the period.

At $1.14 trillion, the **worldwide deal volume was the lowest since the first half of 2004**, indicating how heated the M&A market had become in a few years. Hostile bids accounted for 7 per cent of total M&A in the first half of 2009 compared to 10 per cent in 2008. Bankruptcy and distressed sales accounted for $167.4 billion.

Deals were lower across the world. US M&A volume, representing one-third of the global total, was down 45 per cent. **The US was the top country for bankruptcy and distressed sales M&A.** European M&A volume was down 37 per cent, Asia Pacific (ex Japan) down 13 per cent and Japan targeted M&A down 30 per cent. However, Australian M&A volume hit a record half year volume driven by one deal, the $58 billion joint venture between BHP Billiton and Rio Tinto.

Finance was the most targeted industry, led by the US Government's $25 billion conversion of Citi shares. Healthcare was second as a result of two mega deals announced in the first quarter – Wyeth/Pfizer and Schering-Plough/Merck.

Cross-border deal activity accounted for 30.5 per cent of worldwide mergers in the first half, a fall of over 50 per cent, according to Thompson Reuters Mergers & Acquisitions Review.

Private equity firms continued to see major falls in M&A activity during the first half of 2009 with volume at its lowest since the first half of 1997.

»» financial strength (often the case with distressed sales), the parties have identified a potential liability which is not necessarily quantified and needs to be capped, the sale is through a competitive auction and the buyer needs a competitive edge, or where the buyer insures the warranties because the vendor does not want to give them an acceptable cap.

Michael Lea, Head of Financial and Professional Risk at Jardine Lloyd Thompson, says that in the current market, it is often sellers who take out insurance. "Sellers are looking beyond the risk transfer element itself to beautify the offering by adding warranty and indemnity insurance. Cover with a well-rated insurer is facilitating the deal."

Offerings improve

The underwriters for warranties and indemnities tend to be those active in the D&O and professional liability market. There is about £100 million capacity in the market. "The offering is getting better and there are fewer exclusions," says Lea. "Insurers are even prepared to cover fraud risk from the vendor, if the deal team isn't involved."

"There is a huge focus on environmental liability," adds Lea. "Some companies are comfortable with all the other representations and warranties, but are still worried about the environmental liabilities."

In the past, he explains, there tended to be a strong element of counter-selection in the purchase of warranties and indemnities cover insurance, so prices were high, perhaps 5 per cent of the limit. Now they are more widely used, it's possible to get coverage for 1 per cent or less, depending on the individual circumstances.

> "There is a huge focus on environmental liability. Some companies are comfortable with everything else, but are still worried about environmental liabilities."
>
> Michael Lea, Jardine Lloyd Thompson

The buyer must also revise its D&O cover, Lea advises, because circumstances have changed. For example, the cover will need to include prospective directors, and it should start before any presentations to investors or a public offering of securities.

After the deal has been completed, the group will want to rationalise insurance arrangements, including captives. A newly merged group of any size may have one or more captive insurers, and the new group is likely to want cost savings from merging them or closing and running off the less attractive one.

According to James Pryke, an Associate in the Global Risk Solutions division of Jardine Lloyd Thompson, the acquiring company will usually want to bring its acquisition onto its insurances and cancel duplicated policies. Doing this involves technical work looking at wordings, exclusions, retentions and limits. "Insured retentions may vary widely between acquirer and target, according to the size and age of the businesses and risk appetite. Multiplying the size of the retention can have a significant effect on business units," Pryke explains. There will be compliance issues, since certain classes of insurance, such as third party motor and employers' liability, are subject to regulation.

The sale and purchase agreement will take known liabilities into account, but the most problematic classes are public and product liability, especially where there is the possibility of a long tail such as pharmaceuticals and medical devices. Liability policies could be a mixture of claims made and occurrence wordings.

The insurer can find itself being asked to assume a lot of new risks but without much time or information to underwrite them, according to Sally Roberts of Zurich's M&A Group team. "We will want claims experience, ideally five years, and information about the acquisition's operations so we can understand how the claims are related to the business: territories, turnover and business activities. We want to understand the future plans. Is it going into particularly problematic sector or territories, for example? If we know, we can probably assist," she says.

Pensions and employee benefits

Even more than for property-casualty risks, pensions and employee benefits require specialist knowledge for the new group to achieve the best results from rationalisation, comply with all the local requirements and keep track of costs, especially when there are multiple schemes in operation. "The pension issues need to be understood quite early in the transaction," states Andrew Savage, a Regional Director at Jardine Lloyd Thompson's Employee Benefits division. A material shortfall in a defined benefits (DB) pension (final salary scheme), where employees have been promised a certain level of pension on retirement, can be a deal breaker. Pensions are highly regulated and within Europe the rules vary significantly.

Volatile asset values and longer life expectancies have currently thrown many DB schemes into deficit. Even though many companies have now closed their DB schemes, they have years of obligations to existing members. Research by Jardine Lloyd Thompson's Pension Capital Strategies (PCS) revealed a £90 billion pension fund deficit among FTSE 100 companies at the end of June 2009, compared with an £8 billion deficit at the same time in 2008 and a deficit of £50 billion at the end of April 2009.

Key challenges

One route out is to cap the company's liabilities for a DB scheme by selling it to a specialist insurer who will run it off to the end. There are half a dozen specialist companies in this market.

The biggest issue in bringing together two employees benefits schemes is life insurance for any employees who are absent from work due to a serious illness. The buyer's insurer, explains Pete Whittington, a Partner in Jardine Lloyd Thompson's Employee Benefits division, may be reluctant to accept the life insurance element of the package, and it will need careful work to negotiate with them or with the previous insurer to continue the cover.

The challenges of successful acquisitions in the current market are considerable, yet the opportunities clearly make the endeavour worthwhile. Insurance allows buyers and sellers to make the leap together, knowing that even in the worst case, they are protected from the risks thrown up by both the market and the merger itself. RS

i Michael_Lea@jltgroup.com

Lee Coppack is editor of *Catastrophe Risk Management* and *InforRM*, and former editor of *Global Reinsurance*.