

■ Common Mistakes Observed in Insurance Related Transaction Due Diligence

Christopher J. Veber
Equity Risk Partners (Chicago)
cveber@equityrisk.com



A common refrain recently in the private equity deal community is that deals are taking a longer to execute. While financing considerations are certainly an issue, this longer lead time on deals may also be due in some part to an increasing level of sophistication on the part of buyers and their advisors. Having learned from the process in past acquisitions, many buyers are employing an increasing level of due diligence in transactions of all sizes.

Due diligence is a catch all-phrase, but in a deal context can include an analysis of Operations (operational benchmarking, review of key client relationships, information technology and human capital assessments, etc.), Accounting (quality of earnings tests, working capital needs assessment, etc.), Tax (tax efficient deal structuring, tax exposure analysis), and Legal (contracts, leases, intellectual property, outstanding litigation, and deal structure, etc.) issues at frequently simultaneous or overlapping stages of the deal process.

One additional area of due diligence that has seen an increase in activity or depth is Insurance. In order to perform a thorough review of a target company's property & casualty and employee benefits insurance programs, knowing what to look for is as important as steering clear of the most common due diligence pitfalls. Following are the top ten most common insurance and employee benefits mistakes in the due diligence process.

Property and Casualty ■ ■ ■

- 1 | Target Company Contractual Obligations** – Often customers and/or suppliers impose specific insurance requirements on the target company (e.g., business income and extra limits, umbrella/excess liability limits, etc.). Not examining the insurance requirements in these contracts not only puts these relationships in jeopardy, but it can also put the company at a competitive disadvantage. In addition, not enough attention is paid to determine whether the insurance requirements are reasonable and have any merit. Very often, we will also see certain senior lenders impose unattainable or “out of market” Business Income or Extra Expense limits on the target company. Therefore, it is important to review lender's terms and conditions and push back when appropriate.
- 2 | Historical Premium Audits** – Most Workers' Compensation and General Liability policies premiums are based on audited payroll and/or revenue figures from the former policy period. In the event the target company has not increased these projected payroll or revenue figures to account for cost of living adjustments or corporate growth, this results in an initial understatement of the premium. As a result, additional premiums upon audit at the end of the policy period are due. This is a common oversight, and many companies fail to analyze the results of premium audits and whether invoices for additional premium payments have been issued (and paid) and/or refunds given.

- 3 | Balance Sheet Reserves for Loss Sensitive Programs** – Too often there is a failure to determine whether there are adequate reserves set aside to cover the expected losses within layers of risk retained by the company, including possible adverse development involving a loss sensitive program for Workers' Compensation, General Liability, or Auto Liability coverage. The target company's methodology in determining a self-insurance reserve might have been based on non-actuarial techniques, and as a result, understated by several hundred thousand dollars or in certain cases millions of dollars. Obviously, this can wreak havoc on a deal. In addition, there is little (if any) consideration given to the buyer's exposure to post-closing collateral requirements associated with these types of plans. In today's environment, most insurance carriers frown upon highly-leveraged businesses, and take a conservative approach to underwriting these types of risks.
- 4 | International Exposure** – Understanding how the company's international exposures are being covered (e.g., global policy, local policies, etc.) and confirming that all local requirements are being satisfied is extremely important. It is not uncommon for the target company to have multiple policies in place, issued by different insurance carriers. Each policy appears to cover the same exposures, and therefore represents redundant expense, which creates potential difficulties in coordination of coverage when more than one policy applies to the same loss. For example, we often run into situations where more than one policy applies to all operations outside of the United States, its territories and possessions, Canada and Puerto Rico.
- 5 | Change in Control Provisions** – Upon a change in control, claims-made policies will cease to provide coverage for any claims made post-closing for events alleged to have occurred pre-closing. Certain insurance carriers will provide a waiver of the change in control provision if they are provided some minimal underwriting information regarding the transaction. Absent a waiver to the change in control provision, the current policy in force will go into what is commonly referred to as "run-off." As a result, a new policy must be procured prior to closing in order to eliminate a gap in coverage. It is not uncommon for insurance carriers to use this policy provision to generate additional premium and/or terminate a relationship, especially if the target company's loss experience has been poor. Therefore, it is important to give ample time (minimum 10 business days) in order to respond to the insurance carrier's decision.

Employee Benefits ■ ■ ■

- 6 | Impact of Divestiture on Benefits Costs** – Having a good handle on the "number" is imperative during the due diligence process. What is the aggregate cost to the company of insurance premiums, claims, fees, etc. on an annual basis going forward as compared to what the current parent company is allocating to the business? Additionally, most people neglect to examine the impact of employee benefits choices (i.e., transition from an employer paid to voluntary vision and/or dental plan) for the spun-out entity given its smaller size.
- 7 | 5500s** – Determining whether the target company is compliant with all Internal Revenue Service and Department of Labor rules and regulations is important. If it is not compliant, be prepared to pay some large fines. For example, plan administrators filing a late report may be assessed \$50 per day without a limit for the period of time they failed to file. Companies that do not file a report may be assessed \$300 per day up to \$30,000 per year until a report is filed and compound year over year. It is also important to note that significant penalties can apply to 5500 filing "scofflaws," and there are no specific statutory limitations on how far back compliance enforcers can go in auditing a delinquent filer.
- 8 | IBNR (Incurred But Not Reported) Reserves** – If the company has a self-funded medical program, is the reserve for IBNR adequate? Frequently, there is no proper determination of how the IBNR should be treated post-closing. This can be accomplished by properly documenting whether the buyer or seller is responsible for any shortfall. Common industry practice would suggest at least 1.5 to 2 times the average monthly claim expenditure as the target range for IBNR reserving. For example, if the target company's recent average claims of approximately \$350,000 per month, an IBNR reserve of between \$525,000 and \$700,000 would appear to be appropriate.
- 9 | 401(k) Plans** – These plans are frequently found in target companies today. Buyers need to understand what these programs cost and whether they should be maintained going forward. In general, it is easier for the acquirer to adopt the current plans as the plan sponsor post-closing. This approach will create the least employee disruption and conserve assets for their intended use. However, if the plan is under an IRS audit, which could take several months to complete, it may be prudent not to adopt the plan as is. Sometimes operational issues can be uncovered during an audit that subject the plan sponsor to IRS penalties. Thus, the buyer should retain the flexibility in the Purchase Agreement to replace the current 401(k) plan with a comparable new plan. If a decision is made not to adopt the current plan, implementation of the new plan will need to start four to six weeks prior to the anticipated close date at a minimum.

10 | Employee Contribution Strategy – Not examining the costs associated with moving the healthcare contribution rates closer to the regional or national averages if the target company’s current contribution levels are different from the averages can have a significant impact on the company’s overall profitability. In general, most employers pay approximately 70% for employee-only medical coverage. If the target company’s current contribution amount is significantly richer than regional and national benchmarks, an opportunity exists to reduce corporate expenses through market-reasonable plan design changes. For example, reducing the employer’s contribution level from 80% to 70% would have a meaningful impact on the company’s net costs, especially if the company’s annualized projected medical expense is several million dollars per year.

In its most basic form, all transactional due diligence is a risk based activity meant to uncover risks and other related issues so that they can be factored in to deal negotiations. However, in many instances risk management professionals are not the first to hear about deals when they are announced. Engaging risk management assistance as part of the overall transactional due diligence effort can help buyers avoid significant hidden costs by avoiding these ten common mistakes and many more.

Christopher J. Veber is a Managing Director for Equity Risk Partners, a full-service insurance brokerage and risk management consulting firm focused exclusively on the needs of the private equity industry and its portfolio companies. Mr. Veber has more than fifteen years of experience in mergers and acquisitions, with a particular focus on the middle-market buyout community. Mr. Veber can be contacted at cveber@equityrisk.com or 312.980.7856. For more information about Equity Risk Partners, visit www.equityrisk.com.