UPDATE FOR CLIENTS OF

SECOND OPINION INSURANCE SERVICES, INC.
&
ARMITAGE, INC.

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#5 DUE DILIGENCE RISK EVALUTATION FOR MERGERS AND ACQUISITIONS ©

HOW TO AVOID PAYING TOO MUCH
IN A MERGER OR ACQUISITION
BY PROPER RISK EVALUATION DURING
"DUE DILIGENCE" OR BEFORE
THE TENATIVE AGREEMENT.

THIS PRIMER COVERS PROPERTY,
CASUALTY, WORKERS COMPENSATION,
BENEFITS AND PENSION.

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PAST: UPDATE ISSUES

1. Brief summary for COBRA for the Employer. (10/22/88)

2. Structure and Rationale for Section 89(k) and Section 89. (12/88)

3. 52 COBRA Questions and Answers. (2/92)

4. Family Medical Leave Act (FMLA) – as it relates to Worker's Compensation and COBRA. (2/1/96)

5. Due Diligence Risk Evaluation for Mergers and Acquisitions. (4/97)

<u>Comments:</u> This is the "Columbo" technique for investigation. The three phase study pattern set forth here is repetitious by design. It is how you gain accuracy. The <u>General</u> section has quick and dirty high points and procedures with people. <u>Phase I</u> is the collection of data (property and liability is emphasized first) before signing a draft agreement along with recommended agreement language. After signing and after working with the people (hopefully you are communicating at this point); Phase II begins. <u>Phase II</u> attacks the benefits, people issues and reviews Phase I. <u>Phase III</u> is to go through it all again before final agreement and during due diligence. <u>Phase IV</u> is how to quantify problems before the sale is finalized.

Whether you are purchasing Stock (a Business) and/or the physical assets, the following check list is vital. It is critical because of the nature of merger and purchases. If time and tide were right a stronger party simply acquires through the marketplace. You just compete them out of business with time. Therefore, by definition a merge is no clean victory. Unseen risk is always a problem.

I hope this check list will help you all avoid pitfalls. <u>As requested by several of you , I have tried to make it brief.</u> I did not succeed.

Cordially,

David A. Trapp

P.S. All parties must have benefit of Counsel who must render opinion before signing. This paper is not a Legal Opinion.

P.S.S. Acquisition Risk Management is one of the services of Second Opinion Insurance Services, Inc.

“All past and present insurable interests to be transferred must be protected.”

GENERAL

1. Insure all previous entities, as the buyer you have “successor liability”.

   To minimize this exposure, experts recommend the following terminal actions: make the purchase with cash instead of stock; change the name of the product, location of the plant and it’s management; expressly decline liability for the acquired firm’s products; avoid taking over contracts to service the predecessor’s products; and maintain the seller’s existence for as long as possible.

2. Check Pollution Liability Exposure:

   a. Is there prior to 1980 Liability Coverage?

   b. Does current “Environment Impairment Liability” exist?

3. Review Director and Officer Liability of seller and buyer. Is litigation pending?

4. If there is hostility, is “Tender Offer Insurance” available to the Seller or in force?

5. The Seller is instructed to keep all insurance contracts in force for a minimum of 60 days (or to next renewal) after they are acquired or merged.

6. Ask for all ADA Qualified Job Descriptions and FMLA documentation.

7. The three keys for Employee Benefits/Pension Transitions are:

   a. Measure the “real cost” of all plans for current and retired employees.

   b. Get the employees “back on track” and out of benefit or compensation issues as soon as possible. Answer all issues.

   c. Reassure in a second communication, so you have absolute acceptance of changes in compensation benefits.

8. If there is not time or it is impossible to gauge the problems of the seller, suggest the seller purchase complete “Retroactive Liability” coverage. (Very costly.) **Or DO NOT BUY**

PHASE I

"Collect documents at the time of first evaluation, before the offer, when all financial data is gathered."

A. Prior to signing anything begin collecting:

Your data should include copies of all insurance policies and claims information, details on loss sensitive rating plans that are still open to adjustment (and related documents such as indemnity agreements, promissory notes and letter of credit requirements), copies of later carrier inspection reports and carrier service applications for later major renewals, internal claims handling documents, safety, security and prevention data, risk management manuals, OSHA reports, contracts and the like.

Ask if there are any unusual liabilities or pending lawsuits that may affect negotiations or that affect the value and soundness of the acquisition?

The extent to which the selling firm is self-insured or under-insured may have bearing on the net value of the company. The quality and extent of reinsurance and adequacy of reserves should be verified.

If a cash flow plan or self-insurance program is used, the length of its existence is significant. If started only a year or two ago, the company's profit and loss statement will look unrealistically good because incurred losses have not yet been paid to equal annual incurred losses.

If a compensating balance with the bank is used, working capital is overstated and should be discounted accordingly.

Corporate finances will also be affected by contractual relationships of the firm to be acquired. For example, if sales contracts must be cancelled, how severe will be "liquidated damages" as stipulated in the sales agreement.

1. Get an on-site look of the facilities.

2. Where products are involved, get a copy of all previous primary liability and umbrella policies, showing insurer, policy number, coverage dates and limits. Go back as far as possible and save these policies.

3. Evaluate these exposures for products claims.

4. Obtain complete loss history, preferably ten years but at five. Give attention to claims which have a long payout period, such as products or professional liability and workers compensation. Get a list of all large medical, disability and severance pay (past claims) and current. Estimate a figure for incurred but not yet reported (IBNR) claims. Check for incorrect classifications and audit for any additional premium. Evaluate the effect of using the acquiring firm's experience modifier for Workers Compensation.

5. Verify open claims and sufficiency of coverage.

6. Review workers compensation policies and claims. Look into the possibility of an occupational disease exposure.

7. Set up funding mechanisms for known and unknown losses.

8. Review major contracts, leases and agreements for liability or insurance implications.

9. Review OSHA records.

10. If plants are acquired, pay special attention to environmental impairment. Are there any past citations? What corrections were taken?

11. If an entity is to be spun off, be alert to possible professional liability exposures from advice to be given after the divestiture.

B. Then check the Risk related language in the agreement.

1. Assign responsibility to one firm or the other during the interim period for damage or loss of property being conveyed, or for claims arising out of the acquisition.

2. Require the acquired form to keep all insurance policies in force until notified otherwise. (See #5 B below).

3. Stipulate that *broad* named insured clause for the newly merged or acquired entities be added to all relevant policies.

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

5. If the acquisition is by purchase of assets, specify that the insurance policies of the selling company are not 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 that proceeds of sale. Even after dissolution, there is a period of time in which the distributed assets can still be legally attached. The selling company's liability policies must remain in force.

6. If continuation of insurance (such as on property or automobiles) is desired, contact the broker or carrier and have new policies issued effective at the time of the transfer of title of the assets.

7. Stipulate in the contract that the seller continue liability insurance at least 3 – 5 years for products sold and services rendered before the merger, particularly if claim-sensitive products are involved. Verify certificates of insurance annually.

   Special care is needed with claims-made policies; they cover only claims made during the policy period. Check for “laser” endorsements that exclude products claims or occurrences.

8. Provide for special wording in the purchase contract to give the acquiring firm the benefit of the selling 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.

   In the past, the purchase-of-assets method was held to protect the purchaser from liability for the past misdeeds of the acquired company. This concept has been challenged in the courts. It is more important than ever, therefore, that the quality of the insurance carried by the acquired company (prior to the date of acquisition) be evaluated.

9. Environmental or pollution liability is a serious concern. Check for underground storage tanks, past use of property and disposal of possible pollutants. It may be worthwhile to get a professional evaluation.

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

C. Visit the County Court House of the Seller’s County and sites of operations for list of past and pending law suites filed with Clerk of Court,

PHASE II

"Due diligence review between the Date that the Agreement is signed and it's effective date." (30 to 60 days.)

A. Keep all policies (buyer and seller) separate if the risks are different and, if similar, blanket the coverages only after 90 days, the next renewals, or at fiscally significant date in the future. <u>Separation must exist if you have not broadened coverage prior to purchase.</u>

B. Protect the reasons for acquisition not just bookable assets. (Customer lists, copyrights, patents, product, key people, or <u>contracts</u>.) <u>Check Key Staff against health and disability claims data.</u>

C. Obtain a schedule of all property. How is owned, value and how insured when last appraised.

D. Identify ownership of all "critical equipment" in process.

E. Need flow chart to gauge Business Interruption exposure and consequential exposures. Does any machinery have a long order time? What lack of an upstream supplier can put you out of business?

F. <u>Workers Compensation</u>

   1. Review all aspects before canceling or changing (classifications, loss exposure, experience modes, dividends, statutory requirements, compliance and safety programs). Do not let bad experiences taint good.

   2. Expect increased Workers Compensation costs with downsizing or plan closings.

   3. List ongoing Workers Compensation problems (i.e. Ime's, Hearings, Voc. Re.)

   4. Check leased employees exposure.

G. <u>Detailed checklist for benefits review.</u>

   1. Watch these areas:

      a. Visually inspect all plan documents.

      b. Interview managers, human resource representatives and employees about the plans.

      c. Do not rely on hearsay.

      d. Be suspicious of turnover in the human resources department in evaluating adequacy of documentation.

      e. Include treatment of postretirement benefits for Directors or Key People.

f. Investigate any legal guarantees of benefits made to specific employee and/or retiree groups affected by the merger.

2. <u>Collect all this benefits data:</u>
   a. Plan documents and contracts for all benefit programs including special programs such as adoption assistance, dependent care, EAP, Severance Pay and tuition assistance. All corporate non-P & C policies along with billings.

   b. Summary plan descriptions for all plans.

   c. Most recent summary annual report for each plan.

   d. Stock option plans, incentive plans, SERP's, termination and/or employment agreements, deferred compensation agreements and amounts.

   e. Actuarial reports for any plans.

   f. Audits of any plans.

   g. IRS From 5500 for all benefit plans for must recent two years. (Itemize the large disability and health claims.)

   h. Any IRS determination letters for plans.

   i. Annual reports, proxies, prospectuses and other SEC filings for the last two years.

   j. Employee benefit communications for the last two years, including employee handbook and meeting guides.

   k. Contracts and all plan documents with insurance companies, consultants, brokers, administrators, HMO's, recordkeepers, multi-employee benefits groups and trustees.

   l. Most recent pension plan valuation report.

   m. Most recent FASB 106 valuation report.

   n. FASB 112 report.

   o. Listing of plan participants for each plan.

   p. Listing of employees not participating in each plan.

   q. Number of employees.

   r. Number of employees on medical leave.

   s. Number of employees on leave of absence (other than medical).

   t. Number of employees on workers compensation and pending claims.

u. Number of employees on long-term disability.

v. Number of employees on COBRA.

w. Number of retirees.

x. Number of retirees receiving benefits.

y. Number of retirees receiving pension benefits.

z. Number of retirees receiving medical benefits.

aa. Retiree plan descriptions.

bb. Retiree benefit communications for the last two years.

cc. Description of sickness benefit policy and short-term disability plan.

dd. Status of accrued unused sick leave and short-term disability plan.

ee. Description of vacation policy.

ff. Status of unused vacation leave.

gg. Special services such as employee discounts.

hh. Other benefit liability costs such as grandfathering or past service populations that are not readily apparent.

ii. Unemployment insurance plan documents.

jj. Golden parachute and termination contracts.

kk. Severance pay plan filing.

ll. Employee Assistance Program

mm. Flex Section 125 Reports

nn. Finally check the Corporate Minutes for non-insured plans.

H. <u>Qualified and non-qualified plan problem areas to check potential Excise Tax problems.</u>

1. It is not difficult for an acquiring company to incur sizable federal tax obligations from its inherited pension and benefits program.

   Situations that can trigger tax liabilities are:
   a. Prohibited transactions.

b. Failure to satisfy minimum funding standards.

c. Excess contributions.

d. Certain ESOP transactions.

e. Disqualified benefits in funded welfare benefit plans.

f. Excess fringe benefits.

g. Excess golden parachute payments.

h. Reversion of assets from qualified plan.

i. Failure to comply with COBRA.

I. <u>Crime</u>

1. Allow no lapse if fidelity coverage

2. Check certified audits (do they include stock?) and find out how payrolls are handled along with and other money or security risks. Who has check signing authority, deposit authority, and who verifies bank accounts?

3. Check for prior fraud.

4. Extend fidelity coverage to any terminated employees.

5. Are their security plans adequate? What pre-employment checks are done on employees?

J. <u>Directors and Officers</u>

1. Determine if the buyer will pick up the seller's officers.

2. Check employment practices, claims and potentials.

   a. ADA Status of facilities.

   b. Potential Civil Rights Claims.

   c. Number of women and minorities in positions of power.

3. Have seller extend their old Directors and Officers for 1 year.

4. Review both corporations bylaws for Indemnification of parties.

5. Check prior and pending claims; check for instances which could lead to claims?

K. Liability

1. Any open claims? What is the legal history of the seller?

2. Are limits adequate with risk climate and assets to be protected?

3. The acquiring company's liability must become excess automatically over the buyers insurance plans to avoid and possible non-concurrence.

4. Are there any liabilities to be assumed or imputed? Try not to assume prior liabilities of the seller. Check to see if an "accepted assignment of interest" in prior controls is needed.

5. Beware of your carrier agreeing to acquire the same premium levels of the seller "Subject to Audit". You will have extra charges for excess liability coming.

L. Successor Liability. (See General, Page 2)

1. Weigh products liability exposure in light of Court Decisions in California, Illinois and New Jersey. These states have the strongest laws.

    a. You can change the product, personnel and physical location of the seller.

    b. Buy assets not stock and dissolve the Corporation.

    c. Avoid implied acceptance of previous deeds.

    d. Cancel all past seller's business contracts and notify all that they do not exist.

    e. Add on indemnification clause to the contract – hold harmless. (Good Luck)

    f. Buy "Successor Liability Insurance".

PHASE III

Review all existing and past insurance contracts of the seller for other liability exposure (third time through).

A. Pay the buyer’s local agent/broker to stay around for 1 year or until complete transition is done. The broker is the history you will need.

B. Set new loss control standards.

C. Remember any self-insured agreement is either an increase assets or a liability. <u>What is it and how big for how long?</u>

D. Re-negotiate the price based on this study.

   1. Reduce as much short term risk as possible (more fixed costs and fewer variable costs). Short term equals 1 year to 2 years.

   2. After controlling large losses and liabilities, then fine tune the Extra Expense and Business Interruption coverage.

   3. All policies of all entities must be in one place after merger.

   4. Communicate all changes to all levels. Stress safety.

   5. Unify all claims procedures with “your” people.

PHASE IV

You now can increase or decrease price at the end of Due Diligence.

1. Any new risk that is unacceptable, but assumable, can come from these sources (increased premiums, gaps, agreements, higher future benefit costs, etc.) will lower value of the seller.

   By how much should the value by adjusted $______________?

   How much of this can be transferred $________________ ; at cost $_____________? And by what method?

   a. Insurance Contract, at what cost?

   b. By avoidance of risk (do not buy something).

   c. Risk that can not be handled lowers the values long term. How is this risk amortized and over what period of time?

2. Are there some “acceptable” long or short term liabilities to be assumed that will now affect the value?

3. Final price minus risk equals offer to purchase or the agreed price.

Sources: (Snell, Norman vs., “The Role of Benefits in Mergers and Acquisitions”, CBI October 1992 – Garmi, Gabor, “8 Tips to Avoid Crashing Your Pension and Benefits Operations in Mergers” Pension World June 1993 – Warren, David, Practical Risk Management Topic B-6, 1991 – The Risk Report “Merger and Acquisition Considerations” July 1996 – assorted check lists from the 1997 Property & Casualty National Underwriters Field Guide)