

# **RISK MANAGEMENT DUE DILIGENCE**

## **MERGER & ACQUISITION TRANSACTIONS**

Merger and acquisition transactions are *caveat emptor*, buyer beware, because any outstanding or unknown liability usually becomes the responsibility of the new owner. Liabilities can go undiscovered if the acquired organization has not fully identified its own risks, or neglects to tell the buyer about a known unfunded risk. Therefore, part of a due diligence review is a professional risk audit to determine any unfunded liabilities; otherwise an acquiring organization might become burdened with severe undisclosed and unanticipated liabilities.

### **Risk Management Audit**

Although each merger or acquisition will have its own set of risks, a risk management due diligence audit should do at least three things:

- (1) uncover hidden or unknown liabilities that the acquiring organization may inadvertently assume
- (2) analyze and, if necessary, make changes to the acquired organization's risk management program to improve coverage and, possibly achieve cost savings
- (3) manage the risks created by the merger or acquisition itself, such as shareholder or wrongful employment practices lawsuits

The audit should be done once a letter of intent between seller and buyer has been signed. Although the scope of a risk management audit will vary depending on the type of transaction, such as a simple asset purchase or stock purchase, three areas of investigation should be included:

### ***Organizational***

Analysis of organizational structure and effectiveness of the risk management function

### ***Financial***

Evaluation of claim or loss reserves that may be accrued on financial statements; and an investigation into the funding methodology used for payment of claims

### ***Technical***

Investigation into the existence of liability coverage for discontinued products, environmental risk or other catastrophic exposures; an evaluation of the design and structure of directors and officers liability; an overall analysis of insurance contracts and other risk-transfer mechanisms

Typically, it is beneficial to consolidate programs where possible. By doing so, gaps in coverage may be avoided, the cost of operation may be reduced, and the company sheds the responsibility of administering two programs.

### ***Organizational Audit***

- Determine which corporate risk management team will survive; if none in place or if a merger, will a new risk management team be created?
- If an acquisition, need to identify the person who will coordinate the detail of processes required by the risk management team, such as claim reporting, issuance of certificates, data gathering, etc.
- Will there be a selection of third-party administrators, or other vendors, such as management information systems or actuarial services?

### ***Financial/Technical Audit***

- Thorough review of acquired organization's operations, with careful examination of the manufacture of products or the rendering of professional services
- Inventory of current and historic insurance policies and associated risk-financing agreements (inventory will give insight into some of the risks faced by the acquired organization, however, not all risks may have been identified, and the absence of a particular kind of insurance does not mean the exposure does not exist)
- Contractual Obligations: review of all major leases and contracts for assumption-of-liability clauses; review of prior joint ventures where seller may still have liability
- Uninsurable Exposures: if known, review how the organization manages the exposure; if unknown, identify and determine a management program
- Scrutinize the Risk Management Program for serious problems such as impairment of limits, inadequate loss reserves, or ill-managed or out-of-date captives
- Balance-Sheet Liabilities and Loss Reserves: accruals for balance-sheet liabilities should be developed from claim-reserve data; actuarial estimates of future losses and reserves may be warranted if such losses and reserves will be subject to high deductibles or self-insured retentions, or are otherwise not covered by insurance; if

there are substantial reserves outstanding from past incurred liabilities, a strategy to reduce or eliminate such costs may be needed (loss portfolio transfer)

- Review of “buy-and-sell”/definitive agreement: most agreements will obligate the buyer to protect the seller from D & O liability for some stipulated period; such protection may involve continuation of the identical terms & conditions of the seller’s existing D&O
- Discuss Employment-Related Issues: the reality of mergers & acquisitions is that they create some duplication in operations that cannot be financially justified; when such duplication occurs, the layoff of employees may be required, along with shifting of job functions, or promotions and demotions; such actions come with the heightened possibility that wrongful termination, discrimination, or other employment-related suits will be brought against the acquiring or acquired organization; for this reason , an employment practices audit should be performed that investigates the adequacy and legality of existing employment policies and procedures; also need to review the status of all open arbitration, EEOC and other regulatory-agency filings, lawsuits, or other employment-related disputes

## **Required Data**

### ***Property***

- Copy of current policy showing all terms & conditions, including all endorsements
- Asset Schedules – to provide current replacement cost values by type of property
- Description of property to include address, occupancy, construction type, square footage, fire detection and suppression systems, security systems
- Loss Information – currently valued five (5) years historical experience – for all entities

### ***Crime (Fidelity, Computer Fraud, etc.)***

- Copy of current policy showing all coverages, terms & conditions, including all endorsements
- Copy of current application indicating number of ratable employees and number of total employees
- Names of all ERISA regulated pension and profit sharing plans, including corresponding amount of assets in each plan (for ERISA Bond)
- Loss Information – currently valued five (5) years historical experience – for all entities

### ***General Liability***

- Copy of current policy showing all terms & conditions, including all endorsements
- Complete description of Named Insured, including all subsidiaries and ownership

- Revenues - current and five (5) years historical – for all entities
- Copies of contracts and leases
- Loss Information – currently valued five (5) years historical experience – for all entities

#### ***Automobile***

- Copy of current policy showing all terms & conditions, including all endorsements
- Vehicle schedule including year, make, model, VIN, usage, and garaging location
- Driver List including name, date of birth, and Driver License number
- Additional drivers for Drive Other Car Coverage (for those persons who are provided a company car for business & personal use)
- Loss Information – currently valued five (5) years historical experience – for all entities
- Five (5) year historical vehicle count – for all entities

#### ***Worker's Compensation***

- Copy of current policy showing all terms & conditions, including all endorsements and signed rating plan agreements
- Payroll by state by classification code – current year only
- Payroll – five (5) years historical (annual totals) – for all entities
- Copies of Employee Manuals, Safety Manuals, and Loss Controls
- Loss Information – currently valued five (5) years historical - for all entities
- Experience Modification Rating Worksheets

#### ***Umbrella***

- Copy of current policy showing all terms & conditions, including all endorsements
- Loss Information – currently valued five (5) years historical experience – for all entities

#### ***Errors & Omissions***

- Copy of current policy showing all terms & conditions, including all endorsements
- Copy of current E & O application
- Loss Information – currently valued five (5) years historical experience – for all entities

#### ***Directors & Officers***

- Copy of current policy showing all terms & conditions, including all endorsements
- List of current Directors & Officers, including those sitting on outside boards
- Loss Information – five (5) years historical experience

#### ***Miscellaneous***

- Copy of current and five (5) historical financial information, including (if applicable) Annual Report, 10-K, 10-Q, and any recent S-1's or Offering Memoranda

- Copy of current Business Plan, showing all pro-forma information
- Copy of any other policies, including DIC, Fiduciary, Employment Practices and corresponding applications and loss information
- Copies of all Bonds
- If acquisition, copy of Definitive Agreement

***Employment-Related***

- Copy of Employee Hiring practices
- Review of discipline and termination procedures
- Company Handbooks
- Employment Contracts
- Review of Sexual Harassment awareness training
- Copy of anti-discrimination policies and procedures
- Review fairness of employee benefit programs and profit-sharing plans