



## MERGER AND ACQUISITION DUE DILIGENCE EVALUATION AND CHECKLIST

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An important part of the merger and acquisition process is the risk management due diligence evaluation. This evaluation can affect the sales price, the terms and conditions of the purchase agreement and the finalization of the merger and acquisition.

The risk management due diligence should uncover undisclosed and unexpected liabilities and exposures that the acquiring company could assume as a part of the merger and acquisition. The risk management review should assess the acquired company's risk management program and look for opportunities to improve the coverage and save costs after the merger and acquisition is finalized.

The risk management due diligence process is important for a number of reasons: (1) the growing number and complexity of insurance products; (2) the unpredictability of court decisions regarding whether the successor company is entitled to the insurance assets of the acquired company when claims arise; (3) the increased complexity of insurance claims and lawsuits; (4) the high cost of litigation; (5) the increasing number of long-tail claims; and (6) insurance companies looking to avoid providing coverage for claims presented to them for acquired companies.

Three areas should be evaluated as a part of the risk management due diligence review. Those areas are: (1) Organizational, (2) Financial, and (3) Insurance Coverage. This paper will discuss each of those areas.

### **Organizational**

1. Obtain a complete acquired company corporate history, including a schedule of any acquisitions and divestitures included within the acquired company.
  - Determine whether each acquisition/divestiture was a stock or asset-only purchase.



- For each transaction, obtain a brief synopsis of how the liability transfer or retention was treated
  - Obtain copies of Buy-Sell agreements and other documents for each transaction.
2. Obtain the organizational structure of the company's risk management staff, with names, titles, phone numbers, fax numbers, and location.
  3. Analyze the effectiveness of the acquired company's risk management function.
  4. Obtain the articles of incorporation, by-laws, corporate minute books, and stock transfer records of the acquired company, as well as the same records for other predecessor companies of the acquired company.
  5. Obtain federal and state tax returns and related reports of the acquired company including audit reports, real estate tax bills and payment records, personal property tax bills and payment records, franchise, license, capital stock, doing business and similar tax reports.
  6. Obtain agreements and other documents related to stock subscription agreements, loan, line of credit or other financing arrangements, tax sharing agreements or arrangements, overhead allocation agreements, management services or personnel loan agreements, guarantees or keep-well arrangements for the benefit of creditors or other third parties.

## **Financial**

1. Obtain a schedule and description of all outstanding casualty liabilities related to the acquired company. Include a description of the claim, complete with product involved, location involved and alleged failure. Obtain also a description of insurance available to pay each claim, and where applicable discuss those claims which, for any reason, fall outside of the scope of coverage provided by the company's insurance program.
2. With respect to the total acquired company, obtain a summary showing ten (10) years of aggregate losses by line of insurance.



3. Determine whether there are any sole source supply relationships, major customers or interdependencies that could lead to a heightened CBI exposure.
4. Determine whether there are any instances where product lines or services have been discontinued or recalled due to potential hazards to or claims by customers.
5. Review current contractual obligations for liability or insurance implications.
6. Review OSHA records.
7. If plants are acquired, determine whether there is any environmental impairment. Are there past citations? What corrections were taken?
8. Evaluate uninsurable losses and exposures.
9. Evaluate the pension and post-retirement liabilities.
10. Determine whether buying out significant, open litigation has been considered.
11. Determine whether alternative financing options have been evaluated.
12. Determine whether environmental remediation expenses are covered by insurance or whether they have been capped by insurance.

## **INSURANCE**

1. With respect to the acquired company, obtain a schedule of insurance for as far back as possible, but at least five years showing insurance company, broker, policy number, coverage trigger (i.e. occurrence vs. claims made), limits, deductibles and coverage term. The schedule should include a historical coverage chart for general liability. If "claims-made" policies exist, there should be an explanation the structure of applicable retroactive dates and when occurrence policies were last used.
2. Require the acquired company to keep all insurance policies in force until notified otherwise.
3. Stipulate that the broad named insurance clause for the newly merged or acquired





company be added to all relevant policies.

4. Require any insurance policies of the acquired company that come up for renewal during the interim period to be reviewed by the acquiring company.
5. 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.
6. Provide for special wording in the purchase contract to give the acquiring company the benefit of the acquired company's insurance. This is crucial for any claims based on occurrences prior to the date of acquisition.
7. With respect to the acquired company, determine whether there are any unique issues that have impacted the design of the insurance program (coverage, deductibles, etc.).
8. Environmental or pollution liability is a serious concern. Check for underground storage tanks, past use of property and disposal of possible pollutants.
9. Visit the county court house of the acquired company's county and sites of operation for a list of past and pending law suits.
10. With respect to property insurance for the Purchased Business, obtain a schedule of subject locations, domestic and foreign (either owned or for which the company is responsible for the coverage). Obtain the following information:
  - Address, square footage, type of construction, property values and primary use.
  - Property values (at "Replacement Cost" value) should be broken out to provide separate values for:
    - Building
    - Machinery and equipment
    - Inventory
    - Business interruption.
  - Obtain any property appraisals, (including risk analysis and loss calculations for west coast earthquake exposures), conducted in the last five years.
  - Obtain any insurance company loss inspection reports and business interruption worksheets for the most recent year.



- Identify ownership of all "critical equipment" in process.
11. Determine the existence of liability coverage for discontinued products, environmental risks or other catastrophic exposures.
  12. Evaluate the design and structure of D&O liability insurance.
  13. Evaluate any captive insurance relationships.
  14. Evaluate the process of selecting agents, brokers and other service providers.
  15. Evaluate the solvency of insurance carriers.
  16. Determine whether current policies indicate that assumed liabilities have been transferred to insurance carriers. Determine whether any uninsured liabilities have been accrued for.
  17. Determine the following with respect to insurance program collateral obligations and accruals:
    - Do paid and reserved loss data confirm that accrual information is accurate?
    - Is net worth accurately stated?
    - Will letters of credit limit the availability to use debt for operational purposes?
    - Have loss portfolio transfers been considered as a means of resolving balance sheet issues associated with historical self-insured claims?
  18. Obtain copies of all historic insurance applications. Obtain any notices of cancellation of insurance policies as well as evidence of payments of premiums paid on policies and notices of audits or calculations of retrospective insurance premiums received from an insurer.
  19. A copy of any database used to manage claims.
  20. Obtain copies of all claims files, including notice letters to the carriers and all correspondence from the carriers (including denial letters).



21. Determine the following:

- Have the risks been adequately covered?
- Has the acquired company provided all of the policies? Are there any missing policies?
- Are the policies claims made or occurrence policies?
- Are there any gaps in insurance?
- Are the limits adequate?
- Have the limits been exhausted or reduced?
- Are subsidiary and related companies covered?
- Are there any joint ventures?
- Are there retrospective premiums payable in the future?
- Should the buyer combine any policies with the seller's policies? If so, will there be policy cancellation penalties and if so, how much?
- How will the merger or acquisition affect the workers' compensation insurance experience rating and premiums?
- Have there been any notices of cancellation, policy amendments or reductions in coverage?
- Are the policies written by financially strong insurers?
- Should the buyer purchase prior acts coverage?
- Who will own the insurance assets and be responsible for existing and future claims, including claims that arose before the sale but are made after?
- Should insurance proceeds for any particular claims be assigned, providing the applicable law permits assignment?
- Should any of the parties purchase insurance for or as a result of the transaction itself, such as representation and warranties insurance, acquisition expense insurance, tax opinion insurance, pollution insurance, or one of several types of intellectual property insurance?

22. Estimate a figure for incurred but not 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.





23. Verify open claims and sufficiency of coverage.
24. Review workers compensation policies and claims. Look into the possibility of an occupational disease exposure. List ongoing workers compensation problems and check leased employee exposure.
25. Set up a funding mechanism for known and unknown losses.
26. Evaluate fidelity coverage. Extend fidelity coverage to any terminated employees.

## **Conclusion**

The risk management due diligence evaluation during a merger and acquisition is very important. It can have a long-term effect on a company if not done correctly. While the foregoing check list is not all-inclusive, it should give those in the company who are involved in the merger and acquisition process the guidance to seek the requisite information needed. There are insurance products available to assist companies involved in a merger or acquisition. For instance, representations and warranties insurance provides coverage for losses arising from unintentional and/or unknown breaches of a seller's representations and warranties made in the agreement. Other insurance products often purchased for mergers and acquisitions include litigation/contingent liability insurance, environmental liability insurance and tax liability insurance, to name a few. Companies should evaluate whether purchasing any insurance products to help transfer risk in the merger and acquisition process is a viable option.