M&A RISK MANAGEMENT: COLLATERAL LIABILITIES AND SOLUTIONS

By Seth Gillston, with commentary from Tom Kim

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Executive Summary

When global companies and private equity firms engage in mergers and acquisitions, they often confront obligations to provide collateral that are associated with the target entity's insurance programs. These obligations specifically involve past and ongoing financial risks emanating from the deductibles or self-insured retentions that arise under the target entity's workers compensation, automobile liability and general liability policies. These liabilities, in some cases, may be absorbed by the target entity's wholly-owned captive insurance facility. Different state regulatory requirements can further complicate the treatment of these obligations to provide collateral.

Similar liabilities affect the acquirer in instances where the target entity has substantial surety bond requirements, which now become the acquirer's obligation to fulfill and collateralize. How best to address such collateral responsibilities from an efficient risk transfer standpoint is the subject of this ACE Progress Report. The paper builds upon a series of other ACE Progress Reports assessing M&A risks.

Global Mergers & Acquisitions

Global mergers and acquisitions are expected to rise significantly through 2013, given anticipated corporate profit increases in virtually every industry sector. "The world's largest companies are bouncing back ... with profit expectations up seven percent from six months ago," said David Simpson, KPMG Global Head of Mergers & Acquisitions. "The capacity to transact continues to rise as companies pay down debt. Overall net debt is forecast to drop 12 percent globally, and global net debt to EBITDA ratios are expected to fall 19 percent over the next year."[1] Already, 2013 is off to a robust start with respect to M&A transactions. In January, it was reported that Michael Dell and private equity group, Silver Lake Management, were in talks to take Dell Inc. private; while in February, Berkshire Hathaway and 3G Capital announced its acquisition of H. J. Heinz and Co.

Companies with strong balance sheets, inexpensive debt and significant capital are expected to continue to pursue growth through mergers and acquisitions, despite the fluid economic climate. There has also been a recent trend for large conglomerates to break apart and focus on core businesses. In both cases, potential purchasers need to perform due diligence of the target entities' ongoing liabilities, with respect to their retained self-insured risk or deductible reimbursement obligations.

These financial obligations in an M&A context typically arise from exposures relating to primary liability lines of insurance, such as workers compensation, automobile liability and general liability. In some cases, the target company may have transferred these loss exposures to a company-owned captive, an insurance company that insures the risk of the parent organization and its affiliates. Vital considerations in M&A due diligence are to address these exposures in a cost-effective manner and to protect the entity from the potential volatility of these liabilities, i.e., their adverse or unanticipated loss development.

> Project planners should also work with their insurers to determine the most effective risk management strategies before a project begins and while it's being built.

Corporate risk managers understand that the assumption of post-transaction financial liabilities are quite common and require careful consideration. "In many of the industry sectors we look at from an acquisition standpoint—health care, manufacturing, retail, energy—obligations to provide collateral can be a material issue," said Thomas Kim, Global Risk Manager at global investment firm KKR (Kohlberg Kravis Roberts & Co. L.P. together with its affiliates, KKR) in New York. "Insurance related collateral and guarantees are one of the top five insurance due diligence items."[2]

Obligations to Provide Collateral

Mr. Kim provided an example of the financial impact of an obligation to provide collateral in the context of general liability and workers compensation. "We may be looking to buy a retail chain," he said. "The target company may have thousands of employees lifting boxes and customers coming in and out of its stores on a daily basis, and workers compensation and slip and fall claims can be quite frequent. As risk managers, it is our responsibility to understand the frequency and financial severity of such claims, how to best prevent and manage occurrences, and how the target company is currently valuing the ultimate cost of these claims and financing them. Do they self-insure these liabilities? Do they buy a large deductible program from an insurance company? Do they finance these liabilities through a company-owned captive? These are all important issues related to collateral that need to be understood prior to signing up a deal to purchase the target company."

In such cases, the risk manager will identify strategies to contain or reduce the target's collateral obligations with an insurance broker and specialty M&A insurance company. Mr. Kim said, "The insurer will want collateral, typically a letter of credit, to backstop these self-insured financial obligations. The reason is because under a deductible structure, the insurer is obligated to pay losses within the deductible and then get reimbursed from the insured. If an insured were unable to reimburse the insurer, the insurer would be on the hook, so they want collateral for those obligations." He continued, "As we inherit the existing program from the seller, we may want to review our options with an insurer to buy out the existing liabilities and thus reduce our collateral obligations."

The widespread use of letters of credit (LOC) to secure the payment of potential future losses has its drawbacks, however. For instance, letters of credit can tie up huge amounts of the acquirer's capital—it is not uncommon for a target entity's self-insured financial obligations to reach into the tens of millions of dollars, Mr. Kim noted.

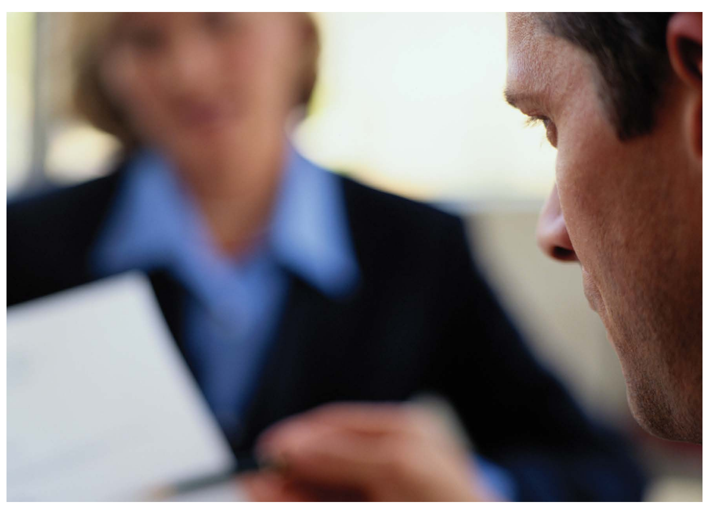
Both the long-tail nature of workers compensation claims and the potential latency of claims illustrate the issue. As an example of this distinctiveness, he cited the risk of an employee who is exposed to a latent disease at the worksite and does not experience health issues for 20 or 30 years, at which point he or she then files a claim for which lifetime care would be necessary. Mr. Kim stated, "That's the complication. It can take a significant amount of time for the liabilities to manifest themselves and the payout could be over a long period."

Another nuance is the statutory treatment of workers compensation. Each state has its own regulations for providing wage replacement and medical benefits to employees injured in the course of employment. In certain states, a company can apply to opt out of buying commercial workers compensation insurance and instead self-insure the financial loss exposure. Added Mr. Kim, "States' rules on posting security vary. Some states require 100 percent letters of credit to match the amount of estimated total incurred losses, while others do not. A company that posts zero or few LOCs prior to the sale may require significant amounts of LOCs after the sale depending on the post-closing capital structure." Thus, there may be an obligation to provide collateral, not only to an insurer (securing liabilities in other states), but also to the state in which the target company is a qualified self-insured.

Failing to appreciate the nuances of a collateral obligation can be problematic in a merger or acquisition, Mr. Kim added. A letter of credit is not the only or the most efficient, cost-effective way of collateralizing post-transaction self-insured liabilities. Other financial arrangements, such as Loss Portfolio Transfers (LPT), Allocation and Assumption Agreements, or even a trust account through which a private equity firm can cross-collateralize its entire portfolio's aggregate self-insured financial exposures, are other ways to manage an acquirer's obligation to provide collateral. The latter alternative can also be an effective way for an insurance carrier to secure a private equity company's surety bond obligations. Each of these solutions is addressed in the next section of this report.

Mr. Kim provided an example regarding a surety obligation in an M&A situation. "Say a private equity firm is looking to acquire a service provider that contracts with state government entities and is required to post surety bonds guaranteeing the performance and completion of work," he explained.

"If for some reason, halfway through the project the company cannot complete the contracted work, then the surety bond comes into play to protect the customer from financial risk. Prior to the acquisition, the company may only post minimal collateral for this surety. The insurer may use the acquisition as an opportunity to review the credit profile of the company and may require it to post additional collateral, potentially up to 100 percent of the bond. When this change is equal to millions of dollars of new collateral, it can materially impact the economics of the deal."



Methods to Manage a Target's Collateral Obligations

Loss Portfolio Transfers

In seeking to ring-fence the obligations imposed by a target's self-insured retentions or deductible liabilities, an LPT product presents optimum efficiency and cost-effectiveness. Such products also protect from adverse loss development and can reduce the amount of collateral posted with an insurance company or, in the case of self-insured workers compensation liabilities, with a U.S. state. There are also potential tax benefits that warrant a conversation with tax counsel.

An LPT is a retrospective insurance program in which a specialized M&A insurance company assumes the uncertain, future payment obligations related to past liabilities (in the context of this report, the self-insured retention liabilities). In other words, the LPT can be structured to absorb the financial liabilities of the self-insurance or the deductible, thereby serving as an alternative to posting a letter of credit to absorb the acquirer's obligation to provide collateral.

> In seeking to ring-fence the obligations imposed by a target's self-insured retentions or deductible liabilities, a Loss Portfolio Transfer product presents optimum efficiency and cost- effectiveness.

The LPT may be more cost-effective than the traditional solution in that the premium paid to transfer the deductible risk could be less than the amount pledged in an LOC. In determining the premium, the insurer typically considers the time value of money and the expected payout. Other advantages to this approach include:

- The previous collateral is typically released and future collateral/LOC costs are mitigated.
- The known and unknown liabilities are converted into a fixed payment.
- The acquiring company's balance sheet is protected from volatility associated with these liabilities.
- Some LPT features may reduce the cash outlay for the premium.
- Some LPTs contain a "swing program" option based on pre-set triggers and loss development factors that may generate an additional or return premium, while still providing significant risk transfer.

Acquiring companies and private equity firms that inherit multiple captives post-merger or acquisition may also find utility in an LPT, as a mechanism to close out the captives.

Assumption and Loss Allocation Agreements

Another alternative to an LOC is an Assumption and Loss Allocation agreement. This approach is useful for a company that sells part of its business, a division, for instance, to another entity. Post-transaction, the seller's insurer would be liable for the division's self-insured liabilities, and would seek collateral from the acquiring company to absorb this legal responsibility in the event of loss.

Here is how the use of an Assumption and Loss Allocation agreement with the target entity's legacy insurance carrier would work: The company that sells the division would enter into an agreement whereby it, and the buyer, have separate collateral, payment and reimbursement obligations. The parties to the agreement would essentially establish their respective responsibilities for payment of the historic liabilities to the insurance company absorbing the risks. In effect, the historical obligations are bifurcated, with each company having separate collateral, payment and reimbursement obligations to the insurance company. Each company would then receive a separate annual collateral calculation going forward, based on their own allocated loss experience and financial strength, which brings more efficiency to the post closing process.

Private Equity Portfolio Trust Arrangements

A third alternative solution pertains primarily to private equity firms. Traditionally, target companies within a private equity portfolio each must post collateral for their own individual self-insurance or deductible obligations in the form of an LOC, trust or surety bond. An alternative is to establish a trust account for the benefit of the carrier, under which the firm can cross-collateralize the liabilities of its portfolio companies on an aggregate basis. Assets from the trust account are drawn to pay losses in case one or more of the portfolio companies default on its obligations. Since the likelihood of all the companies defaulting in a given year is minimal, this is a far more efficient and cost-effective way for an insurance carrier to collateralize the deductible liabilities.

For example, let's assume that five companies within a private equity portfolio each post a $10 million letter of credit as collateral for their respective deductible obligations. The total amount of outstanding collateral is $50 million, representing a significant commitment of capital.

By utilizing the trust account approach, the liability obligations would be cross-collateralized, and the risk of one company defaulting on its obligation is offset by the other company's risk of defaulting. Consequently, the amount of collateral that needs to be held would be reduced. Capital may then be freed up for more strategic purposes. Nevertheless, there are details to be considered and addressed, such as the possibility that a portfolio company may exit the facility if it is subsequently sold—hence the need to partner with a specialized insurance carrier.

The trust account alternative also has applications for private equity firms in circumstances involving the surety bond obligations of portfolio companies. Rather than absorbing the credit risk of each company separately, the surety insurer would absorb the risks of the entire portfolio on a cross-collateralized basis. The risk-offsetting nature of this strategy would result in a lower charge for the surety bond.

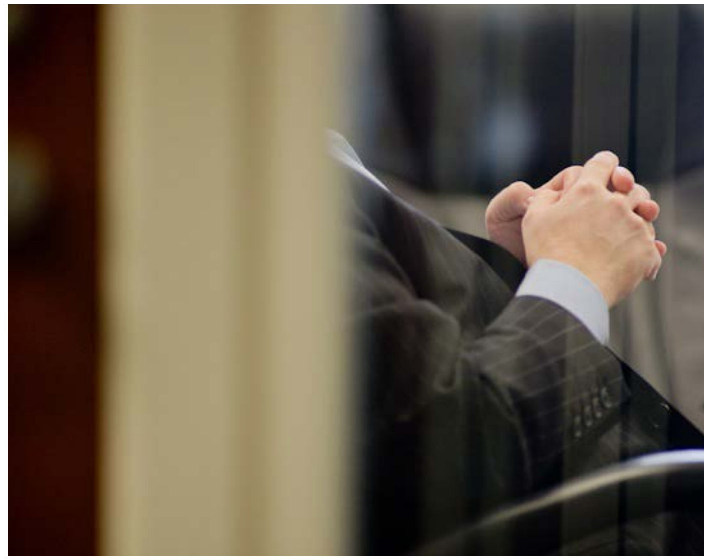
Mr. Kim advises fellow risk managers that their due diligence should take into account the full range of options to address the collateral obligations deriving from mergers and acquisitions. "Risk managers can work closely with a specialty insurance carrier to identify potential financial issues and creative solutions that can help facilitate an acquisition."

Conclusion

CFOs, Treasurers, Risk Managers, and their insurance brokers, working with a specialized insurance company like ACE in the context of a target entity's obligation to provide collateral, will drive the development of efficient, cost-effective M&A solutions for both private equity firms and acquiring companies. By utilizing creative approaches such as Loss Portfolio Transfer products, Assumption and Loss Allocation agreements and cross-collateralized trust accounts, companies can attend to their organizations' risk appetite and obligation to provide collateral more efficiently.

ABOUT THE AUTHOR:

Seth Gillston is Senior Vice President of ACE Risk Management and leads the ACE Global Mergers & Acquisitions Industry Practice, which consists of a deal team of specialized product and service experts who concentrate on both private equity groups and strategic mergers and acquisitions.



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Endnotes:

1 http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/MA-predictor/Documents/ma-predictor-july-2012.pdf

2 Interview with Thomas Kim