



As more companies seek merger partners or acquisition opportunities, more executives will be expected to understand the transaction process.



Navigating Safely Through Mergers & Acquisitions

By Dennis L. Schoff

PARTICIPATING IN A MERGER or acquisition isn't something that most insurance executives do every day, although more may have the, um, pleasure of doing so in the near future. Individuals typically are pulled into the process sometime after the starting shot has been fired and well before the finish line can be crossed. Those who don't understand the process beyond the role they're asked to play can wind up making it difficult for the transaction to go the distance. In fact, it's important that all involved in a merger or acquisition understand the process from start to finish and how their pieces of the puzzle fit into the overall transaction. Unfortunately, that often isn't the case.

A transaction team is like an onion, with the dealmakers at the core. Ancillary players from different areas of the business surround the core team and are brought into the process as it unfolds. For many ancillary players particularly, their job isn't to do deals; it's to run systems, administer claims, process new business. No one would expect them to understand the struc-

ture of an overall transaction, and many don't. But what they don't understand and aren't made aware of right away can have a ripple effect with the potential to eventually damage the deal or even destroy it altogether.

Naturally, all deals are different so the process varies as well. Moreover, certain regulatory schemes will control how some aspects of a transaction are structured. While no two deals are identical, the deals I've been involved in have taught me that certain principles generally apply.

The Confidentiality Agreement

Most transactions begin with the potential acquirer executing a confidentiality agreement. The agreement's principal purpose is to allow the seller(s) to disclose information to the interested party with the assurance that it will remain confidential and not be used for any other purpose. The confidentiality agreement

is important for two reasons: It opens the flow of information between the parties, enabling the potential purchaser to negotiate with some knowledge of the property, and it sets the rules of the transaction until a definitive purchase agreement is signed.

Considerations often addressed in a confidentiality agreement include:

- A promise not to disclose that the companies are in discussions about a transaction
- How contacts with the company or property for sale (often referred to as the target company) can be made
- Whether the confidential material can be copied
- How materials must be returned if the transaction isn't consummated with the bidder

The agreement also may specify that unsolicited bids are prohibited (a standstill provision that often extends beyond termination of the immediate transaction). Many agreements also contain a nonsolicitation provision requiring the party to whom the disclosure is being made to agree not to hire anyone from the target company for a specific period of time.

All individuals involved in a transaction should be made aware of the key provisions of the confidentiality agreement, by being provided either a copy of it or a memorandum that sets forth the key provisions.

When individuals asked to assist with a transaction at some point later in the process aren't made aware of the terms of the confidentiality agreement, there's a risk of breaching the agreed-upon terms and possibly damaging the transaction. If, for example, an uninformed employee casually mentions to an agent that a sale is being explored, the leaked information could cause insurance sales to slow down and the value of the company to drop by millions.

If the company is publicly traded, such a leak would not only expose the employee giving out the information to significant potential civil and criminal liability; it also could cause the acquirer to spend much more for the company.

*Communication
among
everyone
involved in
due diligence
is critical.*



Information Memorandum and Initial Bid

In situations where several potential bidders are being approached simultaneously, the second step tends to be issuance of an information memorandum by the seller. This document provides material information about the property for sale that's necessary for interested buyers to submit a preliminary, non-binding bid.

When only one bidder is involved, the seller rarely prepares an information memorandum. Instead, a limited amount of due-diligence information is provided.

In both instances, the potential purchaser generally is required to submit a nonbinding bid, or letter of intent. The bid is requested to determine whether both parties will be able to agree upon mutually acceptable terms.

It's important for the individuals preparing the initial bid to have the information memorandum or diligence material reviewed by experts on the subject matter (e.g., systems, law) so they can identify anything (either positive or negative) that should be considered in determining the bid amount.

Let's say, for example, that the seller's systems aren't compatible with the buyer's, or a class-action lawsuit exists. Consulting experts on those topics is vital to determine the potential costs of the items before calculating a purchase price. A specialist is likely to see potential costs that aren't readily apparent to a generalist. Likewise, an expert might see synergies between the companies that could produce significant cost savings, thus allowing the bidder to make a more competitive bid for the company.

Although the bid is nonbinding, lowering it later is difficult in a competitive situation if the information memorandum revealed matters that weren't fully comprehended by the bidder until sometime later in the process. If the item was disclosed in the information memorandum or in the preliminary diligence information, its potential costs should be considered in the initial bid calculation.

Due Diligence

If one or more of the initial bids leads the seller to believe a deal is possible, one or more bidders will be selected to advance to the next step: due diligence.

One goal of due diligence is for the potential buyer to identify issues that will need to be addressed in the purchase agreement, either through specific contract terms (e.g., warranties, covenants) or by adjusting the purchase price. It's also possible that problems discovered during this phase may cause the buyer to terminate negotiations altogether.

Another very important reason to conduct due diligence is to identify integration decisions that will need to be made. If, for example, the purchase would duplicate the buyer's facilities or systems, a transition plan will need to be developed.

Make sure to include individuals who will be responsible for running the business after it's acquired so they can identify any issues or needs with respect to integrating the acquired business with the existing business. Communication among everyone involved in due diligence is critical.

Too often, information known to one part of the diligence team isn't communicated to the dealmakers or another part of the team until critical aspects of the transaction have already been negotiated or, worse, until after the transaction has been closed. All members of the diligence team must understand that information not particularly important to one group may be very important to another. Let's say, for example, that the information systems (IS) specialists know that the department is staffed primarily by independent contractors. This detail might be very important to those responsible for employee benefits and may need to be addressed in the purchase agreement.

Other details that will be important to whoever will be running the business include differences in the compensation structure, product mix, customer focus, even something as simple as different vacation schedules. The point is that every piece of information must become shared knowledge because the deal is struck at signing, not at closing. Too often, issues aren't raised early because people mistakenly believe they have until closing to work out the details. It's incorrect to assume that requests, much less demands, can be made after a transaction has been negotiated.

Document Negotiation

The agreement to purchase will frequently be in the form of a stock-purchase agreement, asset-purchase agreement, or merger agreement, although it may take some other form if the asset being purchased is a block of business or a distribution system. Regardless of the form it takes, this is the most important document in a transaction. In it, the parties set forth:

- What is being purchased
- The purchase price
- Representations and warranties about the company or property being purchased
- Representations and warranties about the purchaser
- Any covenants or promises made by either party (e.g., how many employees will be hired, noncompetition agreements, transition services)
- Recourse if a representation, warranty, or covenant is breached

(known as the indemnification provision)

- Miscellaneous issues that either party wants addressed

Agreements generally contain a number of miscellaneous provisions, many of which are considered "boilerplate" but all of which should be reviewed. They may have a greater impact on the transaction than initially appears, particularly if a disagreement arises before or after the transaction's closing.

Include all relevant subject-matter experts in the review of purchase agreement drafts and instruct them to raise all business issues identified. The deal team may decide against addressing every issue for strategic reasons, but their decision should be an informed one, not based on someone else's assumption that the issue could be raised later. Likewise, all contingencies and future needs should be considered and, if significant, addressed in the agreement.

Items generally addressed in the agreement include:

- Warranties for any business issue that could not be adequately determined during diligence
- Indemnification for any significant liabilities discovered during diligence
- Covenants addressing any business concerns such as non-competes, transition services, benefit plans, etc.

The draft of the agreement will change as issues are negotiated, and subsequent drafts should be circulated to the same group of people. Not only should the party who identified the issue be consulted about the adequacy of revised language; others should be made aware as well, since a change in terms for one area may affect another.

1/4
CPS
Page 45

For example, if the seller agrees to provide IS transition services using the seller's employees, employee benefits issues may be created that hadn't been present in the agreement's initial draft. As a consequence, a provision drafted to address a systems issue may need to be reviewed by the entire team, as other areas may be affected such as employee benefit matters, space planning, etc.

I cannot overemphasize the importance of identifying any postclosing needs during this stage in the process. This is the time to address any noncompetes, nonsolicitation of employees, and rights to continue using the seller's paper when issuing insurance products. If the buyer will need the seller to perform any functions after the closing, those needs should be addressed at the time the purchase agreement is executed.

Similarly, the buyer should identify any contingencies that could lead to the need to terminate the proposed transaction. If possible, a right to terminate the agreement should be negotiated into the document. If contingencies exist that could cause a diminution in the value of the property, they should be addressed as purchase price adjustments. Likewise for the seller, if potential events could cause the value of the property to increase, a price increase mechanism should be sought. If this could happen after closing, the adjustments can be structured as an earn-out.

Document Execution

Once the parties have agreed to the terms of the transaction, final drafts are prepared for execution. Before the agreement can

be executed, both parties need to obtain the requisite corporate approvals. Other approvals also may be required, but the corporate ones typically are obtained prior to execution as an internal requirement.

Give the transaction team one last opportunity to react to the terms and conditions of the agreement before it's executed.

Likewise, I strongly recommend a final review of the representations and warranties before the agreement's execution. Most often, a memorandum is sent to all appropriate parties for review in order to avoid executing a document that's immediately a cause for breach.

Preclosing Activities

The preclosing stage of the process tends to be the most confusing. Once the document is executed and press releases are issued, many people consider the transaction finished. Little could be further from the truth. Not only must the deal be technically closed, but also several items must be addressed before the closing can occur. From a business perspective, the period between signing and closing is when a great deal can be accomplished to make the postclosing integration of the business go more smoothly.

It's critical that the dealmakers focus on items that must be accomplished for closing immediately after the deal is signed, including assigning responsibilities and ongoing communication.

In connection with the transaction itself, three principal activities should occur at this stage:

■ **Complete any unfinished diligence.** This is the time to further investigate any diligence items that were reviewed quickly. Often, certain matters can't be explored before the contract is signed and the deal has been made public due to the confidential nature of the negotiations.

■ **Follow through on any promises made.** In the transaction, both parties tend to make covenants in regard to what they'll do between signing and closing. These promises must be kept. Examples of promises made by the buyer include: determining how many of the seller's employees will be hired; cloning benefits plans for new hires; filing new products similar to those that had been offered by the seller to give the acquired sales force continuity in product offering. Items the seller may have agreed to include closing regional offices; terminating certain marketing campaigns; or converting systems.

■ **Obtain necessary third-party consents.** This may be the most critical activity, for failure to obtain necessary consents can preclude a closing from occurring. Consents include state and federal regulatory filings such as the Hart-Scott-Rodino filing required of material transactions to ensure antitrust concerns aren't violated.

It may also include consents from third-party vendors. Many contracts, particularly software contracts, will terminate upon a change of control if the vendor's consent isn't obtained. Any internal corporate consent not obtained earlier may need to be procured now as well. For example, very material transactions may require the consent of shareholders or policyholders, in the case of sponsored demutualizations.

Now is also the time to make plans to integrate the acquired property into the purchaser's operations. This may be a source

1/4
SC Intl.
Page 46

of conflict between the buyer and seller, so it should be addressed early. There tends to be tension between the desires of the parties planning the integration, both in terms of exchanging information and actually taking steps to begin the implementation.

In addition, antitrust rules and regulations may require that certain integration activities occur after closing. Working closely with antitrust counsel in planning these activities is warranted.

Also, buyer and seller may strongly disagree on which activities should occur before and after closing. Sellers often have little incentive to engage in these activities preclosing, preferring to let the buyer handle them entirely after the closing for cost and manpower reasons.

To avoid conflict, buyer and seller should thoroughly discuss the proposed activities prior to executing the purchase agreement, and any agreed-upon preclosing integration activities should be documented.

Closing

What occurs during preclosing often determines how smoothly the closing goes. It can be a nonevent, disorganized madness, or somewhere in between.

It's important that people assuming responsibility for the business be made aware of obligations after closing.

During closing, any ancillary documents are signed concerning reinsurance, administrative services, transition services, and similar agreements. Also signed are any side letters regarding matters the parties want to document outside the purchase agreement, such as subleases and software sublicenses.

Certain officers of the company generally are required to sign certificates evidencing compliance with the purchase agreement's covenants, the accuracy of representations and warranties, due corporate authorization, and similar matters. And of course this is when the money is exchanged.

Buyer and seller are expected to arrive at the closing prepared. One closing I was a party to was delayed for 11 days because the buyer (not my client!) hadn't attended to the activities discussed earlier. Several important third-party consents hadn't been obtained, nor had adequate financing. The buyer's ability to pay the purchase price was \$3 million short because the chief financial officer hadn't figured in some important parts of the purchase price calculation. The deal closed only because the seller was willing to agree to last-minute solutions, including accepting a short-term note as part of the payment.

After Closing

Because certain agreements extend beyond the closing, consideration must also be given to postclosing responsibilities. In many cases, the seller must attend to obligations related to transition services, for example. It's possible that a period of non-competition will need to be honored, as well as restrictions against soliciting employees for an agreed-upon period of time.

It's important that everything both parties have agreed to is communicated and honored.

The difference between a smooth transaction and a rough one often comes down to who's in charge. It's a good idea to put one person or a small team of individuals in charge of overseeing the transaction from start to after closing. This individual

or team could focus on postclosing integration issues at the same time the acquisition itself is being studied.

Identifying the ideal person or team depends on the acquiring company and the nature of the deal. The responsibility tends to be assigned to the corporate planning person, legal counsel, or whoever will ultimately be in charge after closing. A company with a strong central planning group, for example, is most likely to assign responsibility there. An acquisition made to satisfy a specific need—to add a product line, for example—might be better off if responsibility is assigned to the corporate officer who must make sure the transaction satisfies the need.

A smooth and successful transaction is more apt to occur when it is someone's job to make sure that everyone involved understands the process from start to finish.

DENNIS L. SCHOFF IS SECOND VICE PRESIDENT AND ASSOCIATE GENERAL COUNSEL FOR LINCOLN FINANCIAL GROUP IN FORT WAYNE, IND. REPRINTED WITH PERMISSION OF LINCOLN REINSURANCE REPORTER.



The entire September/October issue of Contingencies is now available online. Visit us and explore more aspects of the topics in this issue at www.contingencies.org

1/4
Computer
Programming
Page 47