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Key M&A insurance and human capital risks for financial institutions

While M&A activity remained slow throughout most of 2023, M&A activity in the first half of 2024 has shown signs of improvement, and it appears that sentiment among many dealmakers is that M&A activity is expected to further improve throughout the second half of 2024. However, comprehensive risk management to identify and address risks remains paramount to the success of an acquisition or disposal.

Key insurance and human capital risks inherent in M&A

Potential risks that companies seeking to make acquisitions need to address include:

- Availability of insurance cover to pay for claims made post-completion which relate to pre-completion events.
- Inheriting or introducing target company cyber vulnerabilities.
- Inadequate seller financial recourse in the event of a breach of warranty under a sale and purchase agreement and/or a call under a tax indemnity (Breach).
- Claiming for a Breach, which may jeopardise any ongoing relationship with warrantors.
- Pre- and post-transaction insurance and people-related costs that impact the transaction's value.
- The target's senior leadership team not having the necessary skill set to execute the deal thesis.
- Negative impacts on employee relations, potentially affecting employee retention, productivity, and wage demands.
- Failure of the target to meet local requirements around employment and benefit terms.
- Practical and cultural complications of people integration.

These risks are expanded upon overleaf.

Key insurance risks

Mitigating M&A insurance risks can enhance deal value.

Dealmaking conditions remain challenging, and businesses face a growing number of risks which require careful management and mitigation, including:

Uninsured or underinsured legacy liabilities and lack of programme access

An adverse surprise is one of the biggest challenges that can derail an acquisition or lead to unexpected and often unbudgeted costs.

A buyer may suffer an uninsured or underinsured loss if an event that occurred pre-completion, which comes to light post-completion, is not covered under the policy in place at the time of the incident. Thorough due diligence is needed to ensure appropriate coverage is in place for legacy claims that occur before the transaction close.

In addition, at completion, if any gap in cover is not corrected immediately when the target is acquired, a loss that occurs post-completion may not be covered under the go forward insurance arrangements.

If the buyer is only purchasing part of an existing company, they need to gain a clear understanding of how and when they will be given access to prior policies to understand how legacy liabilities will be treated.

Red flag issues may include:

- Material gaps in cover.
- Low policy limits comparative to exposure.
- Significant retentions, making accrued liabilities and exposure to legacy claims significant reserve items.
- Policies providing cover on a claims-made basis that contain limited retroactive dates.
- Policies that will cease to provide cover for the target once the transaction completes.
- The treatment of historic liabilities, limited or no access to historic insurance coverage, and concerns over who will have responsibility for reporting and managing claims.

Overpayment

Costs not properly budgeted for and not factored into the valuation of the transaction can result in a financial institution overpaying for a target business.

Typically, these costs include:

- Increases in the target's cost of insurance going forward, whether that relates to the cost of purchasing "fit for purpose" insurance, or funding uninsured or underinsured legacy liabilities. Such increases in costs will have an impact on the profit and loss account and possibly the balance sheet. The impact of an adverse claims experience should also be factored into future costs.
- One-off costs, for example, the cost of purchasing run-off cover or any necessary risk improvements required by the buyer's insurers going forward should be considered.
- Identifying these costs at an early stage in the transaction can avoid the risk of overpayment.

Key cyber risks

Cyber risk presents a particular challenge for buyers, as cyber vulnerabilities can be inherited through transactions. Traditional due diligence may not pick up on or adequately quantify these risks, which increases the likelihood of cyberattacks and other cyber incidents causing significant losses that could decrease the value of the deal post-acquisition.

Buyers should therefore consider:

- Technical weaknesses and red flags in cyber security capabilities at the target that may pose a risk to the business.
- Previous cyber incidents, including data breaches at the target.
- The costs and income losses arising from a data breach of personal data records, cyber business interruption, including reputational damage, and a cyber incident such as a ransomware attack.
- Future integration issues including any key considerations for the placement process.

Recourse under a sale and purchase agreement

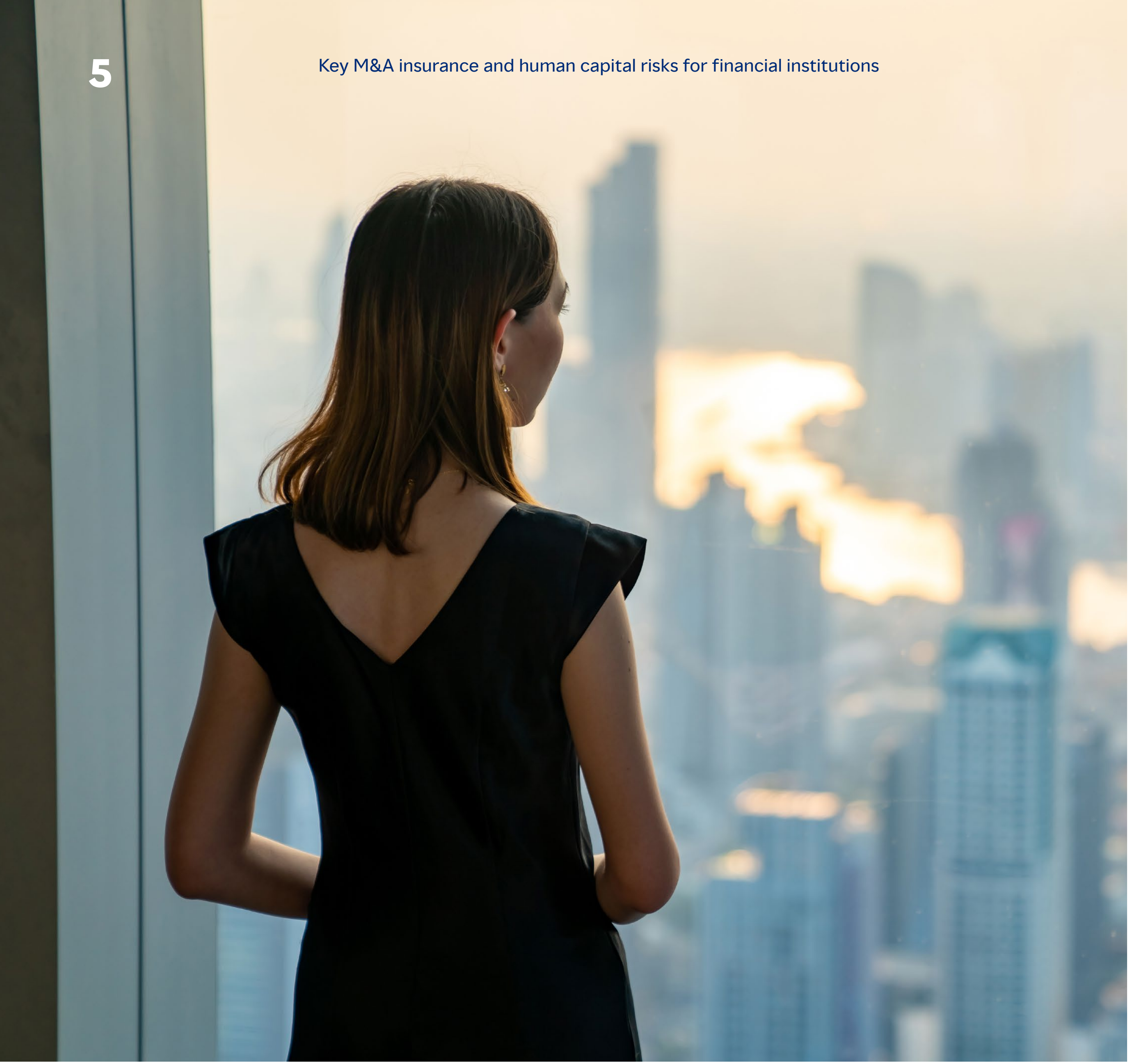
In the context of the sale and purchase agreement, having inadequate recourse in the event of a Breach can seriously impact the value of the business that is being acquired.

It is therefore important to analyse in detail the liability package that the seller is offering, to protect against financial losses arising out of unknown, or indeed known and identified risks.

A buyer should ask a number of questions about the liability package offered, including:

- Is the seller capping its liability at a low amount?
- Does the buyer have concerns about the seller's financial covenant?
- Is the seller a distressed seller refusing to offer comprehensive warranties and indemnities?
- Is the target based in an unfamiliar or unknown jurisdiction from the buyer's perspective?
- Will there be an ongoing relationship between the buyer and the seller going forward? For example, is the seller rolling over any of its shareholding in the target or will the seller be involved in the target, as an executive officer or employee, post-completion? If so, in the event of a Breach, does the buyer want to avoid suing the seller for the Breach for fear of jeopardising ongoing relations?
- Would offering the seller a limited cap on liability for Breaches ease deal negotiations?

If the answer to any of the above questions is yes, then the buyer may want to explore insurance options which can offer protection and potentially ease transaction negotiations.



Key human capital risks

The cost of ignoring people risks in deals can be high.

Deal value can be driven by the target having the right leadership team, skill sets, and understanding of organisational goals. Yet these issues are frequently neglected when a deal is put together. In many cases, they are viewed as items that will be dealt with after the transaction completes.

The unrealised potential of people in deals is not just hypothetical. In fact, research conducted by Mercer shows that the driver of deal shortfalls in 47% of M&A deals is inadequate focus on workforce issues throughout the deal process.

Change in people costs

People costs often make up a significant part of operating expenditure and balance sheet liabilities. If pay and benefits of the acquired business are below market rates and need uplifting, the profit and loss of the target/enlarged group could be impacted. Regarding defined benefit (DB) pension liabilities, while financial market movements in recent times have resulted in material improvements in the funding position of DB pension schemes in the UK and other countries, the risk that liabilities may increase because of the acquisition needs to be understood.

Leadership team issues

Buyers should consider if the target's leadership team is equipped to implement the post-acquisition business plan, or indeed whether the leaders of the target will be required going forward. Any onerous provisions in the leadership team's contracts or pay-outs relating to the transaction need to be assessed. Concerns about the possible impact of windfall payments to that team and other key individuals because of the transaction should be considered, particularly from a retention perspective. Issues relating to a change in leadership roles should also be addressed. These issues could relate to loss of autonomy or the increase in internal processes because of moving from a smaller to larger organisation.

Employee relations and culture obstacles

Integrating an acquired business into the buyer's business often leads to a clash of cultures and working styles that directly impacts productivity and business outcomes. Employee relations can play a significant part in what a buyer is able to do with employees' terms and conditions post-acquisition.

The impact of unions, works councils, and collective bargaining agreements

The impact of unions, works councils, and collective bargaining agreements (common in many European countries) at the target, as well as local labour laws, need to be assessed and allowed for. These may place restrictions on changes to employees' terms and conditions and could have an impact on employee termination costs.

People challenges relating to integration and separation

In a carve out or integration scenario, consideration is needed in the due diligence phase towards:

- Benefit harmonisation.
- Job architecture and pay structures.
- Organisation design.
- Payroll, human resources, and IT.

These items come with costs and challenges that need to be factored into the transaction's pricing and planning.

Suitability of workforce

Issues can arise if the target's workforce does not have the necessary skills needed to fulfil the post-acquisition business plan. This is of particular concern if employees with the required skills are hard to recruit.

Compliance issues

Compliance issues with respect to human resources and pension and benefits procedures at the target could lead to claims from employees and/or fines from regulators that would transfer to the buyer.

Next steps

Failing to address insurance and human capital risks can be costly and threaten value derived from transactions. Financial institutions with concerns related to the above should explore the risk mitigation options available to protect deal value and to help ease transaction negotiations.

To discuss any of the risks outlined above, please contact your Marsh or Mercer contacts.

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