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for conducting a careful and thorough due diligence process.

KAREN KENIFF

Understanding the Fundamental Risks of Mergers and Acquisitions

Every industry sector is experiencing brisk merger and acquisition activity in 2015 — from pharma and food to technology and construction. Like companies across all industries, construction firms are seeking to strategically add value to their businesses through a merger or an acquisition. The value in taking this step comes in various forms, including access to new markets, new customer relationships, geographical expansion, gaining new capabilities, talent acquisition or simply scaling up to compete on larger, more complex projects (whether domestically or globally).

For example, as the economy strengthens, some contractors are struggling to attract and retain a talented labor pool. A merger or acquisition can address this skilled labor gap. For union firms, a merger or an acquisition can also provide access to open-shop capabilities.

"Many contractors have the desire to grow but lack the resources to compete either in new markets or in new high-growth sectors," says Karen Keniff, senior vice president of Zurich Financial Services. She notes that industrial, health care, higher education, energy and power are sectors where contractors are currently seeking attractive opportunities.

To maximize the value of the deal, Keniff encourages owners and buyers

to perform aggressive due diligence around previous and current risks. "Buying a business or merging with another company is a complicated, high-risk proposition," Keniff says. "This is likely the largest transaction of a construction company, and the risks involved are unlike others typically faced by the owners or management."

Beware the Speed to Deal

Mergers and acquisitions move quickly, and the risks can be high and often hidden. Unforeseen environmental liabilities, management liabilities, political risks, and fiduciary and benefits liabilities can all endanger an M&A transaction.

Keniff reminds buyers and owners that managing the appropriate level of due diligence requires time. "Often," she says, "it takes a year or more to manage the details of the process and negotiations."

Failing to adequately assess a company before the purchase can have significant financial consequences and destroy the value of the deal.

While most owners typically think of financial documents and accounting systems as the core components of a due diligence process, a more comprehensive and suitable approach factors in company assets, contracts, labor relations, and insurance policies and coverage.

A Diligent Look at Key Risk Exposures

According to Keniff, due diligence is critical to limiting risk and liability exposures. Failing to adequately assess a company before the purchase can have significant financial consequences and destroy the value of the deal, she notes.

Based on Zurich's experience with contractors of all sizes during M&A transactions, here are questions that should be addressed to help assess potential risks during the frenzied, fast-paced due diligence phase:

Are there any existing exposures?

With the acquisition, the parent company is picking up the new company's exposures. Are there issues around environmental practices or workers' compensation? What is the culture of the company being bought? Are employee relations good, or is there a risk of a lawsuit by disgruntled workers about the merger or acquisition?

What are the contractual obligations being assumed?

In most situations, getting a clean break on contracts isn't feasible because

work is still being performed. Companies that don't closely examine the backlog of contracts — and that wait until after the deal is done — risk losing money during the completion process.

It's particularly important to be aware of union contracts, as the union may need to agree to the purchase. Keep in mind that contract negotiations can be costly and complicated, especially if pension plans are involved.

What is the company's loss history?

To avoid surprises, the buyer should ensure that its private consultant or in-house team looks as far back in loss history as possible. One area to examine closely is the statute of repose that will determine the amount of time in which a party can bring suit.

Is there synergy in risk management practices?

Buyers also need to address disparities in risk management practices and get everyone on the same page. Having a single, consistent risk management program based on best practices can ensure that the appropriate risk appetite is disseminated throughout the organization.

How does the new company manage claims?

From a claims perspective, the parent company should understand the "legacy claims and claims philosophy" of the company being acquired and the differences in how the firms manage claims. There should also be a process in place to absorb ongoing insured claims, which is something the insurance carrier can help provide.

What are the possible post-deal coverage gaps?

Keniff says that once the sale is made public, the buyers and owners should involve their insurance carrier or carriers to help determine exposures and gaps in coverage that need to be addressed, especially Directors & Officers, Employment Practices Liability and Environmental Liability.

Smoothing the Risks Post-Deal

Determining the appropriate types and levels of coverage for the new entity is critical, Keniff says, "as the past can come back to haunt the future in unexpected ways." Below are three key types of insurance coverage that can help protect the entity:

Directors & Officers

The completion of the deal doesn't protect you from the possibility of future litigation against directors and officers (D&O) of the acquired company. And if you sit on a board of a company that was acquired, you could be sued for actions that you took on behalf of the company before it was acquired.

If your company stopped paying annual premiums to place D&O insurance after it was acquired, you and the other directors and officers could face damaging lawsuits.

Employment Practices Liability

There are different employee-related risks in M&A transactions. These can include obligations from unsettled labor and employment law violations or ongoing litigation. Former employees can file new complaints post-deal as well. Some employee benefit-related issues can be challenging to discover, such as if the seller did not maintain benefit plans as required by compliance or if it failed to fulfill fiduciary duties.

Environmental Liability

This liability may arise in various forms, including ground contamination, water pollution or asbestos. There is an increasingly complex body of laws and regulations that dictate successor liability. It's important for a buyer to understand the acquired company's potential liability for past contamination on land owned, past noncompliance with environmental laws, and costs that may be incurred to comply with environmental obligations.

"Every buyer and seller has a different motivation for entering an M&A situation," says Keniff. "But the same principle about risk holds true for both; the ultimate success of the deal requires taking the time and having the patience for conducting a careful and thorough due diligence process." Q

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