Crossing the border

Suresh Krishnan and **Seth Gillston** explore the implications of M&A activity for multinational insurance programmes

Acquisition-minded companies in the increasingly fast global M&A environment are wrestling with how best to structure their post-transaction multinational insurance programmes.

In particular, there is a need to address evolving regulatory and tax compliance issues, while effectively transferring an acquisition's liabilities.

Depending on the target company's operations and risk appetite, the acquiring entity may inherit a range of often-unknown successor liabilities, which can go back decades. Given the increasingly punitive legal and regulatory compliance issues that confront acquirers, it is of paramount importance to manage these ongoing liabilities through a multinational insurance programme that considers the frictional costs related to cross-border insurance and absorbs the successor liabilities in a materially compliant manner.

Structuring a superior post-transaction multinational insurance programme requires an understanding of the laws and regulations in which the target company is domiciled, its insurable exposures in these countries and how these risks have previously been managed and/or transferred.

This is a difficult exercise for global companies to undertake without specialised assistance, given the inconsistent laws of the multiple jurisdictions governing cross-border insurance programmes. For example, it can be difficult to ascertain whether the coverage terms and conditions are consistent across multiple local policies. Acquirers also must understand which lines of business are insured locally and, where there is no local capacity, how to address this void after an acquisition.

These issues are in sharp relief now that multinational M&A activity has intensified. Banks have eased lending terms and strategic buyers and private equity are looking to deploy capital. According to a recent report from Dealogic, global M&A activity through the first six months of 2011 is 22 percent ahead of last year's pace, reaching $1.5tn.

The Asia Pacific region has experienced significant growth in M&A activity, according to a report by Bloomberg. More than 8,700 deals involving an Asian company as the target, seller or buyer were announced in 2010, eclipsing Europe as the second most active region after North America. In China alone, approximately 2,500 deals worth $110bn were reported, representing a 108 percent increase in volume since 2005.

For the acquiring entity, divergent insurance laws and coverage issues raise questions. For instance, what are the coverage terms and conditions of the target company's extant policies? How can the acquirer insure these risks going forward, given restrictions on unlicensed insurers? Will the buyer have access to all of the target's historical insurance programmes? If both the acquiring and acquired companies own captives, how will they be managed and/or consolidated?

Other questions arise in situations where the acquiring entity has purchased 100 percent of the target company and now has an insurable interest in its legacy environmental and litigation liabilities. For instance, what is the strategy to manage these risks in countries that limit global insurance policies?

A joint venture raises other concerns. Will the majority shareholder now have an insurable interest in the liabilities of the other shareholders? Are these liabilities jointly shared among the shareholders or are they "several"?

While the acquiring entity must ensure that a risk management deal team is in place to assess these questions from an insurance standpoint, a decision needs to be reached on if and how the transaction agreement will address perceived coverage voids and/or inconsistencies. For instance, which specific successor liabilities will the acquirer inherit? Would a loss portfolio transfer (LPT) make sense to protect against possible adverse loss development, reducing burdensome collateral requirements?

For many acquiring entities, an LPT may be effective. If the target has acquired numerous entities over time, including some that no longer exist, it may be virtually impossible to determine these entities' continuing liabilities. Post-transaction liability may attach not only to the target company's current products, but also to products discontinued years before. Insurance policies that may have once absorbed these liabilities could have elapsed, provide incomplete or ineffective coverage, or be underwritten by defunct insurers.

Acquirers must also address risks to their executives in the post-transaction environment, since M&A activity is a major driver of costly securities class actions against directors and officers. Acquirers also must determine the target company's current arrangements for protecting its directors and officers.

Again, serious questions arise: Is the acquirer required to indemnify local executives, or must local executives purchase separate policies? After the deal closes, must the acquirer provide additional or specific financial protection to its existing directors and officers to address their post–transaction activities?

These post-deal liabilities must be assessed against the varying laws governing insurance across the world. Nearly every country has laws regulating the licensing of insurers and producers, the insurance forms and rates, the marketing and sale of insurance, the payment of taxes and other obligations.

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Many countries prohibit or limit non-admitted insurance. Other countries – such as the UK, Hong Kong and Singapore – broadly permit unlicensed insurers to assume local risks. Some countries – such as Australia, Canada and the US – have a hybrid regulatory regime permitting some local risks to be assumed by unlicensed insurers, as long as regulations are obeyed and taxes paid.

All acquirers want execution certainty with regard to claims handling and indemnification, but they do not want, or expect, to assume unanticipated regulatory and tax consequences. They want to be reassured, as do insurers, that the insurance they have purchased – whether it is a master differences in condition (DIC) policy or a differences in limits (DIL) policy – will fill coverage gaps and yet still be materially compliant with respective national laws and regulations.

However, such programmes do raise significant compliance concerns. For example, when attempting to structure seamless insurance coverage across national borders, local policies may incorporate by reference coverage terms and limits that do not exist in the local policy, but rather in the master DIC-DIL policy only, and that policy is usually issued and effective only in the jurisdiction of the parent.

Other concerns exist around tax, particularly premium tax and income taxes that may be due as a result of complex inter-company premium allocation and loss payments between the parent company and its affiliated entities. Multinational insurance buyers should consider whether adequate premium is allocated to local policies. They also must determine whether the parent company's premium allocation of its master DIC-DIL insurance expenses to its affiliates is properly documented and substantiated by an arm's-length analysis. These are all elements of a robust transfer pricing arrangement.

These and other concerns will intensify in coming years. Local regulatory and tax investigations in some countries may have been lax in the past, but this is largely no longer the case. Enhanced cooperation among international regulators and many countries' more modernised systems have increased enforcement.

An effective response includes separating local policies from the master DIC-DIL policy. The master DIC-DIL policy can then protect the parent's insurable and financial interests from its worldwide exposures in addition to local policies. Another prudent response is presenting a rational and defensible position on the appropriate premium tax and income tax treatment, with transparent documentation reflecting a course of conduct consistent with the global insurance arrangement.

Finally, including insurance particulars in the closing checklist should eliminate surprise frictional costs from multinational insurance programmes and manage execution certainty across national borders.

Compliance with foreign insurance laws is more critical than ever. Global companies preparing for a merger or acquisition should consider the services of a global insurance provider and local experts in tax and accounting to craft a multinational insurance programme that absorbs the target's retrospective and prospective liabilities effectively, assures execution certainty across borders and promotes compliance.