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Insurance Mergers & Acquisitions Specialty Reference Book: Meet the Authors

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Summary: The insurance industry has experienced and continues to experience substantial merger and acquisition activity from blocks of business to entities, transnational to international deals. Many actuaries have been or will be affected by a merger or acquisition in their career. Mergers and acquisitions have been viewed as complex undertakings. Multiple professional disciplines are involved, such as investment bankers, accountants, lawyers, tax experts and actuaries. The multidisciplinary author team presents its role in the evolution of the text and answers your questions on mergers and acquisitions.

MR. JIM TOOLE: Because mergers and acquisitions (M&A) is a collaborative process, we wanted to use a team approach and let our experts help us decide how to shape the book. We had an idea that we needed to bring something to market, but weren't sure how to make that happen. So, we brought in experts from health, employee benefits, life and property and casualty, as well as from other professions, including the accounting, investment banking and legal professions, to try to help shape that content.

Tom and I worked together to develop the proposal to the Society. We created an outline, and then we met in a nice sunny, sandy location but never saw the beach. We hammered out an outline that was significantly different and much improved from the one that Tom and I originally came up with in our meetings. That's a direct result of working with these many different professionals.

We then had two directed meetings to write and work on the collaborative chapters. In many of these group-writing situations, you'll see one professional or two professionals responsible for a chapter. In this instance, we had chapters where as many as nine different people were contributing to one chapter. I can assure you that that was a challenge.

As to the content of the book, we start out by taking you through the M&A process. Each chapter stands alone. You could read it and come away from it with a good understanding of what we're covering. The M&A process is primarily from an investment banker's standpoint. The finance aspect is geared toward an introductory level, for folks who are less familiar with corporate finance and perhaps need a refresher on that. The valuation standpoint is geared primarily to the actuarial valuation. This is followed by due diligence, corporate due diligence, tax, accounting and integration.

For the first chapter, we've got Tom Herget. Tom is vice president at PolySystems. He's the godfather of this project and moved heaven and earth to make it happen. He is a software provider to the insurance industry, manages the installation advisory services and customer services of his business, and is a former board member of the Society of Actuaries.

MR. R. THOMAS HERGET: John Butler wrote Chapter 1, but he couldn't make it here today. I'll be representing John and tell you what he wrote about. His chapter covers 60 pages. It's segregated into preparing to sell, pre-marketing, marketing, bids, due diligence, final bids and executing the deal.

Regarding preparing to sell, John writes all about reviewing the strategic alternatives to determine if the block, affirming whether or not the company should be sold. Is there anything management should do or could do as an alternative to sale? He discusses the parameters to consider that. Then he talks about assembling the ideal team. If you are going to proceed to sell, whom do you have to get on the team? First of all, he talks about selecting a financial advisor, which is an investment banker.

John notes that the investment banker needs certain skills, such as familiarity with a relevant industry, valuation expertise, relevant M&A experience, knowledge of and contacts with likely buyers, sophisticated financial structuring experience, strategic vision, process prowess and negotiating skill. John himself had most of these traits. The second member of the acquisition team is the legal counsel, third is the accountant and fourth is the actuary. John talks about the types of sales, such as a public auction, targeted auction and privately negotiated transactions. He talks about what exactly is for sale. Is it the total company or just its assets?

Regarding premarketing, he writes about how to qualify potential buyers. Does this buyer have cash or access to cash? Is the size meaningful? Would there be strategic synergies at the end? That's the pre-marketing that helps qualify who could buy this company.

Regarding marketing, he talks about the process, which is a fairly elaborate process. You have a teaser memo, a confidentiality agreement, a confidentiality information memorandum and a bid process letter in which you agree to the rules for bidding. There will also be an actuarial appraisal and the establishment of a data room. When talking about marketing, he discusses how to find initial contacts, how to follow up, how to settle a preliminary bid, how the seller starts to do due diligence and how management makes presentation to the bidders. He then switches to the buy-side evaluation and how the prospects are screened, how the buy-side person retains an advisor and how a formal review is conducted, which includes a market analysis, evaluation and preliminary due diligence.

John then talks about the bid process. He addresses letter of intent, the negotiations, the confirmatory due diligence, arranging financing and discussions with the rating agencies.

Finally, John talks about the steps to getting to a "yes." He looks at how the negotiations proceed, how you update the management and board of directors, the actual agreement itself, its contents, the representations, the warranties, the deal protection and employment agreements with the current employees of the target.

He then writes about regulatory issues, announcing this deal to agents and employees, presenting it to the public and getting shareholder approval. He covers all that in a brief 60 pages. It's fascinating reading.

MR. TOOLE: Next up is a presentation on the finance chapter. This chapter had an interesting prominence because we forgot it. We forgot how to finance the transaction. I sent our outline to my good friend, Mike, to have him look at it. He's president of AIRCO Limited, an AIG subsidiary and global reinsurer in Bermuda. I asked if he could help us out and he said, "You need to put in a chapter right here." He's going to talk about it.

MR. MICHAEL E. GABON: There's actually a little bit more to that. Jim said, "Can you review the outline?" I said, "Well, where's reinsurance? Where's financing? Where are the assets, etc.?" He then talked about the "wrangler" concept, in which each person was to manage a chapter and if you needed little bits and pieces from somebody else, you were to try to get that person to help. He then recruited me to be the wrangler to the first chapter, and I actually got him to contribute to it. So this is a combination of some of Jim's work and some of my work.

Briefly, there are about 60 pages. As background, the idea was to look at how we are going
to pay for this or be paid for the transaction. If you don't think what you're willing to put out is worth it, you may require extra funds. Actuaries are typically not involved in the actual financing, so I think that this would be of interest to them. Typically, it's the chief financial officer (CFO) or someone in that area who's looking at it.

In a company I was with recently, multiple rounds of financing seemed to be the way to go. They raise money in small traunches. Rather than try to raise large amounts, they did it in segments and stages. Obviously, the importance of purchase GAAP implications depends on how you structure the transaction.

The chapter consists of a brief introduction of about five pages about efficient markets and finance theory. Then we go into various instruments, such as equity, trust preferreds and hybrids.

Here's a real live example. About a week ago, the latest deal out there was an acquisition by Scottish Re of the life reinsurance portfolio of ING Re. The press release explained how it was financed. Scottish Re was given funds to help support the collateral requirements. The collateral financings or the collateral structures were maintained so that Scottish Re didn't have to go and arrange for its own collateral. Then they raised an additional $230 million, partly through trust preferreds and partly through a private equity fund, which was used to investing in the insurance industry.

So you'll gain a background on that. I think that it's important for actuaries to understand these types of things; we're often shut out of this domain. I think it's very helpful that we can contribute to the process, to projections of future business, etc., and the various structures. CFOs need to understand what we can bring to this type of function.

There are general market financing considerations, such as interest rates movements. If your stock price is up fairly high, what currency are you using to purchase this other entity? It's very deal-oriented. We also have insurance-specific considerations. Take, for example, the collateral for this reinsurance acquisition. There are also rating agencies and regulatory aspects as well.

MR. TOOLE: Next up is valuation. We are very fortunate that Laird Zacheis was able to write with us. This chapter seemed to spring fully formed straight from his forehead. It required the least work from the editors, and for that we are eternally grateful. Laird is a principal at Milliman, specializing in consulting, acquisitions and U.S. GAAP issues. He graduated summa cum laude from Yale with an MBA.

MR. LAIRD D. ZACHEIS: As Jim said in his introduction, a key objective of this text was to enhance communication between professions and to promote the role of the actuary outside the industry, and, I would say frankly, within the industry as well, in terms of ways that we can facilitate transactions.

This chapter will be familiar to a lot of people. It was written more toward the non-actuarial audience, as were other chapters in the book, which might work the other way to a greater degree. The key topics addressed in the chapter are: what's unique about insurance companies (meaning why the actuaries matter), what's different from a bank and that sort of thing. While it talks briefly about market multiples, actuarial appraisal valuation takes up the bulk of the chapter.

Why are insurance companies unique? There's a very long tail in the insurance liabilities that's very different from most industries. There is a great deal of uncertainty in the value of liabilities. The statutory accounting requirements are a unique area. They govern distributions of cash out of the company, which is what the industry fundamentally cares about. How do we get earnings out of this thing? How do we get cash out of this thing? The unique aspects of the insurance companies, frankly, are what make the role of the actuary important.

A number of my investment banker friends both complain and are somewhat appreciative of the fact that insurance companies deal with some of the hardest deals to both analyze and to get done. There's a great deal of uncertainty in price thinking. Pricing can vary all over the place. Market movement, obviously, can cause great changes in value. There's also a lot of difficulty in actually getting the deal done because of regulatory requirements and the controls over what cash you can get out.

We go through market multiples to a certain degree to focus on things like price-to-earnings and price-to-book ratios both for comparable traded companies and comparable transaction analysis. The great thing about that view is that it's based on very real numbers in terms of reported earnings and observable prices in the marketplace. They're not necessarily the best indicators of value, but they're very tangible and facilitate a quick analysis.

Sales prices are often looked at in dealing with European or Canadian companies. Sales price relative to embedded value is often a very good indicator and a great depth of information is published and publicly available.

The third approach is a discounted cash flow model from a banker's view, which would be more a momentum of GAAP earnings for determining the value applied. This, again, can be very useful. The problem is that 90 percent of the value may end up in determining a multiple. We'll look at eight, 10, 12 or 15 times earnings, but it's all in the multiple. So it's used occasionally, particularly for financial buyers who are looking at an exit strategy, but it's not the key driver of economic value.

One item that's included in this chapter is a list of the significant transactions from 1989 to 2003. "Significant" is defined as a purchase price of $100 million or greater (or something along those lines). It identifies about 60 to 70 life transactions and 60 to 70 property and casualty (P&C) transactions, which come from Bob Shapiro's annual summaries of DLs. It identifies the purchase price relative to earnings or book value wherever that's available.

Then we move on to what is natural appraisal. The objective is to frame it in terms that non-actuaries can relate to and understand. Fundamentally, an actuarial appraisal is just a discounted cash flow analysis with distributable cash flow. The assumptions that go into that are interesting. We spent some time going through how distributable cash flow is defined, because it's not true cash flow. It's not just statutory earnings or GAAP earnings. It's very specifically what cash can come out of the insurance company, which is defined in terms of statutory earnings less the increase in required capital.

Regarding the components and actuarial appraisal, the first item is just a book value or statutory net worth. Then we go through the reasoning for why an actual appraisal is based on statutory accounting as opposed to some other basis. The embedded value then adds in the value of in-force business. The full actuarial appraisal value would add in the value of future business. Finally, total company value reflects other items as well.

It's important to recognize and to make clear to the audience why an actual appraisal value itself is not the value of the company. There may be holding company issues reflecting the holding company net assets and liabilities. There are tax issues. There's the urgency associated with the transaction. Of course, there are differences in viewpoints and assumptions, and that's the biggest item. Each buyer will have its unique perspective on what the assumptions should be. But the appraisal value is the key theoretical construction for building up how to think about value.

In talking with investment bankers, they would generally say that the appraisal value is the best indicator of value and a transaction sales price. Of course, you get into huge issues about value of future business, and that would be very dependent on each situation but, nevertheless, in the insurance industry, deals are generally structured around this kind of discounted cash flow (DCF) analysis.

We then go through a number of issues related to the appraisal and emphasize that the point of the appraisal is not to present a value. There is unique value to start with, as far as the different requirements for discount rate, or for the earnings they'll get off it and the greater return they'll get. Of course, the basis for assumptions will definitely vary. The point of the appraisal is to provide a framework for the buyer or potential buyers to be able to do enough analysis to actually come to their own determination of value. That shows the importance of having sensitivity analysis, having projections of earnings so buyers can see the actual capital requirements and flows coming off it, and fundamentally providing enough information to come to an informed judgment.

Then finally, we spent the majority of the chapter going through specific issues for a range of business lines in life insurance, health insurance and property/casualty. We went over the unique aspects of each of type of business once we defined the overall framework.

An overall example is included. It starts in the valuation chapter for a theoretical, simplified universal life insurance block in a company. We take that through how we look from an actuarial appraisal point of view and how we'd look if you were doing a reinsurance deal. We go through different tax structures for it. We look at the Section 338(h)(10) approach to a deal and what kind of tax benefits would come from that, and we go through a purchase GAAP analysis of it. I want to reiterate the importance of purchase GAAP to your financing decision. The purchase GAAP is very tightly related to the appraisal value, and we share that by an example of how you carry through the analysis for each of those sets.

MR. TOOLE: Next up is Tom Corcoran. Tom is a health actuary and has a lot of experience in challenging fields: LTD, short-term disability (STD) and long-tail lines. He's a principal in the Tillinghast office in Hartford. Because of his wisdom and expertise, he had a most difficult challenge, which was to tie together the due diligence chapter with all these different points of views.

MR. THOMAS R. CORCORAN: We break the due diligence chapter into four topics. It covers: setting the stage as to why you're doing the deal, the objectives of the due diligence process, who is the team and what the process consists of. About half the chapter is devoted to actuarial aspects of due diligence. The actuaries, in fact, probably do have the most critical role in due diligence because not only are they doing due diligence on the financial and actuarial operational aspects of the deal, but, at the end of the day, they have to tie the findings of the entire team back together. They must translate that into adjustments to price that will end up driving a successful bid.

What is the timeline? The efforts start right after the preliminary bid. We assume that the preliminary bid has been accepted. At this point, reliance has been placed on the seller's appraisal and offering memorandum. Thus, the preliminary bid is logically based on potential value. The buyer now has two to five weeks to translate all this potential value into something for which they're willing to pay cash. The team has to analyze and confirm all the objective and subjective criteria that could affect not only the value of the deal or the financials of the deal, but also the success of the deal or the operational things that have to happen in order to realize those financial values. There's a huge team going through and doing all this analysis. The actuary then has to translate that data into a buyer's appraisal value, which is always different from the seller's appraisal value. That is what is used, along with the other professionals, to construct the final bid. This wraps up the due diligence process as we've defined it. I want to let you tie together these different views of due diligence when you're dealing in them.

What's common across a life, property/casualty and health company? It's the investigation and evaluation phases, which is what most people consider to be due diligence. We broke this into three pieces: confirming the strategic value, the strategy behind the deal and whether that strategy will work. If you're assuming that you're going to drive down unit cost because you can export the existing business to your own system, what's involved with that? Will you be able to do an automatic interface on the in-force? What assumptions have to be validated in order for the strategic value or the value behind the strategy to be realized? Obviously, you have to confirm the financial value. The financial value is what people normally think of as the actuarial work. You must look at all the underlying experience studies. Validating what was put into the seller's appraisal is, in fact, something that can be done.

Within this section we defined something called a "buyer's appraisal." The buyer's appraisal takes the seller's numbers and constructs its own view of the world. Usually you adjust the seller's appraisal, but in some lines (for instance, group insurance), you could actually create models from scratch.

Confirming the operational value is a huge piece of the due diligence. The team is dedicated to going through the operations and seeing that the business that you're acquiring is being managed the way that you expect it and that there are no holes—that the claims people are good at managing claims and the underwriters are doing a good job of underwriting the policies. But if there are things there that you need to fix, how much is that going to cost? How long is it going to take you? How's that going to affect the price?

Beyond the due diligence and investigation phase, you move into the implementation phase. You have to take all this information and construct a final bid. The chapter describes that process. During due diligence you also have to prepare for successful integration. This means that you'll have a gap between when you make your bid and, if you're successful, when you close and get the operation up and running. Companies can lose a lot of value between when the bid was made and when you actually have control of the organization. There are a lot of things that happen during due diligence that will determine the degree of success of the final deal.

Who does due diligence? There's the due diligence team. I think everybody is familiar with that. It is the inside experts from the company, actuarial and accounting. There are review teams from all the operational departments to examine the seller's operations and confirm all the things that are going on there. This team makes sure there are no tax problems or benefits resource problems, that all the functions are performing the way that they should and that the system supports the functions appropriately.

The way that this is structured shows that there's a set of outside experts. They are the actuary, the accountant, the investment banker and the legal advisor. They have specialized skills in mergers and acquisitions. They do a lot of deals and they bring that expertise and experience to the M&A process. This part of the chapter describes what each one of those do in the due diligence process.

On one side you see the inside experts. These are company employees. Some companies do enough deals that they have their own M&A specialists, but they usually bring in their operational people as well. In particular, we make the point that if you can, you should bring in the people who are going to own the business after the transaction. They want your underwriting department to roll its actuaries into actuarial departments, so that the person who is ultimately responsible is involved in the due diligence process. We find that when people are going to have to live with the results, they take a lot more interest in getting it right. (Of course, all this has to take place in two to five weeks.)

The other thing we have is management's oversight of the whole process. It's critical that the buyer's management is directly involved in the M&A process. It's not something that can be delegated.

What does this process look like at the end of the day? The timeline is non-linear and non-proportional. A lot of things are going on at the same time. It starts with the selection of a finalist. You have a data request, and the seller prepares a data room. You visit on-site where the seller does presentations. You get to ask questions. While this is all going on, the buyer has already started to develop its appraisal and projection to support the PGAAP performance. As you find things out, it raises additional questions, so there are answers coming back. That's a continuous process. You're feeding the answers into all your models, appraisals and valuations of the business on a dynamic basis. So not only are you doing your projections, you're continually updating your projections based on information as it comes through. Toward the end, or the fourth and fifth weeks, you construct your final bid. However, even while you're constructing your final bid, you're still gathering new information!

MR. TOOLE: Alan Hines single-handedly represented the casualty practice in Chapter 4, the valuation chapter; Chapter 5, the due diligence chapter; and Chapter 6, the other corporate chapter. It was extraordinarily difficult to find one person who could handle all these different things. We're very fortunate that, after a lot of phone calls, we found someone who is able to do that for us. Alan is a consulting actuary for PricewaterhouseCoopers. Al will explain how he handled this.

One of the reasons that Al had to cover all this material is that he was not a wrangler. Because we had so many different contributors, the wranglers of each chapter had to coordinate all the different contributions of the different people. But because Al was so over-stressed by contributing his pieces to all the other chapters, he didn't have to wrangle.

MR. ALAN M. HINES: What I enjoy most about working on merger and acquisitions is the opportunity to work with a diverse group of professionals in order to solve a business problem. You really get to add value to the job. I found this project to be very similar, and I learned a lot from it. We tended to work on our own assignment and forget the other pieces, but when the information came together, we talked about it during our writing sessions, which was an excellent opportunity to collaborate. If you ever have the chance to get involved in something like this, jump on it. As Jim said, I participated in three of the chapters, including the valuation chapter. The interesting thing about property/casualty companies is that very rarely does an actuarial appraisal exist from the seller's side.

I was called in to work on a property/casualty deal to look at some loss reserves for a company in the Northeast that was buying a small company out in the Midwest. Being a good consultant, I went out there and tried to sell them on me putting together a valuation model. But I was told that the reason I was there was because the client couldn't get his own actuaries to agree on what the loss ratio was for the company two and three years ago. Because of that, he said he definitely wasn't going to rely on any actuarial valuation of forecast loss ratios for the next four years, given they couldn't agree on what had already happened. That highlights some of the difficulties with the property/casualty line. I was happy to see that the life company actuaries are doing valuation models to determine the right economic value.

You'll read that the property/casualty companies rely more heavily on market multiple approaches and some more cursory approaches because of the diverse nature of the liabilities and the unpredictability of what the premiums are going to be in the future. Because companies are so different, one of our jobs as property/casualty actuaries is to try to get a set of benchmarks to what the target company is. In this chapter, we talked a little about how we approached that .

When you are performing a model valuation model on the property/casualty side, a couple of key parameters are premium volume and the loss ratio. I'll touch upon the loss ratio difficulties during the reserves. The difference from the life and the property/casualty side is that the premiums or the policies are annually renewable and a lot of these property/casualty companies and specialty commercial line companies are using brokers. If the target company is purchased, the brokers or agents may not renew the policies with the company that's being sold. One of the difficult challenges is identifying and valuing some different assumptions on what may transpire after the transaction takes place.

Loss ratios are certainly a challenge. Property/casualty actuaries will spend a significant amount of time evaluating the loss, loss adjustment and expense reserves. I go through a lot of examples of how the valuation of the reserves from a merger and acquisition perspective is slightly different from an actuarial opinion.

When we're doing an actuarial opinion, we can certify that the reserves are reasonable if they're within, say, -5 to 5 percent or -10 to 10 percent of the actuarial best estimate. But when you're doing a merger and acquisition, especially when the buyer is relying on a market multiple approach, if a company has taken their reserves from an adequacy position of 3 or 4 percent down to +/- 3 or 4 percent, those earnings have significantly impacted their results. That will translate into higher multiples and higher bid prices. So going through an actuarial analysis for a merger and acquisition not only requires you to look at the current reserves, but the prior couple of reserves to see if there has been a change in the adequacy.

In the book we also talk about quantifying some of the material risk factors that exist for property/casualty companies. Most of you are familiar with the asbestos and environmental liability, but we also have mold and construction defects, with new issues coming up all the time. We have to be able to identify these issues and project how much they may balloon for a particular company. This is one of the key values that the property/casualty actuary brings to the deal. There are other valuations of intangibles that we talk about in this chapter as well as in Chapter 8, an accounting chapter.

On the due diligence side for insurance companies, I think there's a difference between the merger and acquisition of property/casualty companies and the life side in that most of the property/casualty acquisitions are strategic in nature. They're looking for a particular aspect of the company, whether it be some technologies they're buying or the ability to grow horizontally and enter new markets. It is all about strategic issues, so the due diligence is sometimes focused primarily on that buyer's strategy. Unfortunately, if you don't spend as much time on the valuation side of the coin, you're going to find companies, right after the deal goes through, having to make a significant increase in their loss reserves. Some of you may have read about issues like that in the paper. Also, because things are strategically driven and the value of the combination may be more than the economic value of the firm, sometimes the priorities of what the actuaries are doing are shifted.

Identifying some of these value drivers or the integration costs when you put the two companies together is very important. For example, on the marketing side, a company agent may be connected to a company through some technologies, and if the buying company does not have those, the business may not roll onto the books as it is expected because the agent will go with the path of least resistance when they're placing their business.

There are marketing issues and underwriting issues. Companies using different underwriting models or underwriting techniques may cause the deal to either gain value or lose value.

Assessing the different risk factors for property/casualty companies can sometimes involve overlapping of markets. If you have a property/casualty insurer buying another smaller company and the agents in that area have both companies in-house, a lot of agents won't want to have a significant book of business with one carrier. They want to keep their operations open. Identifying overlapping markets or synergies from cross-selling of business is one of the aspects of the due diligence that the actuary brings to the table that is somewhat unique to the property/casualty line of business.

When we are performing due diligence, we look not only at the financial aspects, but also at the operations of the company to find out if this marriage will work. It's a different perspective and, hopefully, I have kind of captured it in Chapter 5.

Chapter 6 is on corporate due diligence. We've heard a lot about enterprise risk management. That probably means a lot of different things to a lot of people.

Property/casualty actuaries are acting somewhat as enterprise risk managers, because we are seeing some of the perils that can significantly change earnings of a company when we're out there looking at corporate corporations, not insurance corporations.

I had the opportunity to be an insurance agent. Understanding the different policies and techniques that are out there can help companies determine whether their risk management process is a valuable solution to a combined entity. We look for some of the things that may not be covered by other insurance policies, such as a unique piece of equipment or a single supplier of raw materials. We present those types of issues as a risk factor to the buyer so that they understand some of the concerns and issues that they need to mitigate going forward.

We spent a lot of time in the chapter talking about the uninsured or self-insured exposure for property/casualty risk, primarily the workers' compensation general liability. This is going to be a significant issue in a lot of merger and acquisitions going forward. I'm seeing it right now in the audit field. After September 11, the property/casualty market dried up and the premiums went sky high. The market's response to that was that you assume a little more of the risk yourself. Keep the first $100 thousand of exposure. A lot of companies did that, but didn't understand the concept of "incurred but not reported (IBNR)." As we do M&A work, we're looking for exactly that type of thing. We look for companies that are not funding these long-tail liabilities properly for which they've self-insured.

We talk about the carve-outs, the importance of understanding how a big corporation might allocate its cost of insurance and how the actuary can make sure that it's getting the right cost for a division of a corporation.

We talk about some of the miscellaneous items, which are the things that always pay for my fee for when I go and look at a company. Those are claims-made insurance policies. Often the audit firm or the company looks at it and says, "We're insured. Here's an insurance policy that covers these losses." Well, it's only for claims that are reported through a particular point in time. For any claims reported after that time, there's no insurance. I go out there and look for those types of policies and say, "In order to insure that tail liability, it's going to be X dollars." That usually covers my first consulting fee.

Warranties are another issue. Companies are guaranteeing their products and using the Social Security system's pay-as-you-go method. There are a lot of companies who are not properly accruing for their warranty claims.

Those are the types of the things that the property/casualty actuary will bring to a corporate due diligence project, which I found is as interesting or more interesting than working with the insurance companies.

MR. TOOLE: The wrangler for Chapter 6 is Dale Yamamoto. Dale is a health-care actuarial practice leader for Hewett Associates employee benefits, and he also brought some pension expertise from his firm to this chapter.

MR. DALE H. YAMAMOTO: This chapter is one of the chapters that you can pull out and apply to any kind of merger and acquisition situation because it's not just applicable to the insurance company industry. It's a piece that actuaries get when involved with any kind of M&A activity that's going on in the United States right now. The focus is on all the actuarial elements that we have in the transactions. Alan talked about the property and casualty pieces. I wrote about the employee benefit portions of it. It could apply to any situation. It could apply to a manufacturing company as well as a life insurance company.

The key thing that we included in this chapter is how you identify all the liabilities that can make, break or reshape a deal. What I mean by that is that there are several different things that are going on from a more natural aspect on the M&A deal that could actually be a deal maker.

On one of the transactions I worked on, the target company's health operation had a unique use of its own clinical and technology staff to run its own employee benefit program to help control health-care costs. The buyer looked at that and said, "You know, that has an intangible value to it that isn't a part of anything else in the whole value process." The buyer viewed that as being an extra positive in the acquisition.

A deal breaker doesn't happen very often because usually, when you look at the transactions going on with the benefit programs, there are very few things that are going to actually break a deal. The only time that I've ever seen a deal breaker was when comparing overall benefit programs of two different organizations. You end up looking into the future, asking, what's going to happen in the whole integration process? You can tell a lot from a company's benefit program as to what the overall culture of the company is like.

In one particular situation, we took a look at the target company's benefits and saw a very rich health-care program that took care of everybody, including employees and their dependents in a defined benefit program. It looked like a very paternalistic kind of a company. The buyer was a company that was expanding by looking at a lot of different acquisitions. It tended to be very entrepreneurial, letting individual companies do their own thing and, because of that type of environment, had a relatively skinny benefit program. It looked at and favored cash compensation over benefits. When you started looking at and thinking about integrating those two companies, in the end it was going to prove to be a very difficult endeavor. They decided to not continue with that particular acquisition.

There are also deal shapers. Often when we looked at the benefit programs, as part of the whole due diligence process, we found some significant unfunded benefit programs. What that is going to do is potentially reassess the purchase price of the entity. In the last 10 years, we're usually seeing the unfunded programs in the retiree health-care programs. You also add on some significant executive benefit programs in there, too. Lately we have noticed that, because of the markets, even qualified pension plans have tended to be more on the unfunded side, more so than they have been in the past. We have to look more closely at these situations than we did during the last 10 years.

One of the things that we did when trying to assess what to include in this particular chapter was to think about how much depth to go into. I took a look at the valuation chapter. Laird took a very close look at a lot of the different methods of valuing liabilities and assets. I could have gone that far in this chapter, but if I did go that far, it probably would have been a 150- or 200-page chapter.

The other extreme, something that's a little bit less where the focus is, is making sure that when you're looking at the benefit programs of a target company, you look at what the things are that you ought to be looking for and what you should be careful to pick up. Within the chapter is a transaction list of all the different things that you ought to make sure that you consider when you're looking at and comparing the two different companies, the buyer and the seller. This will help in the initial due diligence process and will help immensely in the ultimate integration. There's a list of all the different benefit programs and the key provisions that you ought to be looking at when you're assessing the differences between the two different benefit programs. There is also a methodology or a way to assess the value between the programs, because things that we look at as actuaries aren't always readily available to the people looking at the transactions.

One of the things that we always do in a situation is take a look at the benefit programs and place a value on the benefits of both the buyer and the seller to make sure that they link up together fairly well. From this you can do one of two things. You look at the richness of the benefit programs between the two companies. During the integration process, it helps immensely with several of the people trying to make some kind of an assessment of the ending cost of the benefit program. Depending on which way they go, do you fold everyone into the buyer's benefit program, or do you make some kind of an integration?

When you look at mergers of equals, you always end up with the situation of wanting to take the richness of every single benefit program that's out there. That's a big failure to a lot of people. If you make that decision, you want to take the best of everything. What's going to be the ultimate benefit cost when you end up doing that? That usually raises some eyebrows and people realize that it's not a good idea.

MR. TOOLE: Next is Hugh McCormick. He's a partner in the New York office of LeBoeuf, Lamb, Greene & MacRae LLP. Hugh is an expert in the industry, and he donated much time to make this project happen. He regularly speaks at actuarial meetings, and he has also contributed a chapter on U.S. regulatory issues for international life insurance.

MR. HUGH MCCORMICK: I am the lawyer in the group. I am a member of the Society of the Actuaries now. Strangely enough, I am a correspondent member and a member of the Reinsurance Section of the Society of the Actuaries. I think we have the largest insurance M&A practice probably of any firm in the world. I represent Scottish Re on a regular basis. I was the lead lawyer on a deal that we just signed a couple of weeks ago, which involved virtually everything that we've talked about here today in great detail.

I was also involved in writing the process chapter with John Butler, which was a lot of fun. That particular chapter is kind of half-investment bankerish, half-lawyerish. But that was kind of an interesting chapter. We tried not to get too much into banking and legal detail, but we also wanted to leave the reader with some sense of how the process works and, in particular, how the banker and the lawyer work together in the legal structuring of the transaction—the bid process, the due diligence process and the structuring of the documents, which is ultimately the part that people do have to live with over time.

I was also involved in some of the due diligence working with Tom Corcoran, and I contributed some of the legal aspects of due diligence where you get into things like closing conditions. When you find the smoking gun, do you close or do you not close? Is it an option to walk away even when you find it after signing the definitive agreement but before you close? Does it fall into what is known as a "material adverse change" clause? You get into some fairly interesting issues there.

Of course, then there's the post-closing due diligence when you find a smoking gun that you didn't find before closing. There you get into questions of representations and warranties and survival of representations and warranties and indemnification clauses, and things like that. These are all lawyerly kinds of issues that are very important to understand if you're involved in a transaction in any industry. The life and property/casualty industries give you all kinds of great opportunities for post-closing due diligence.

You also need to look out for Section 7702 failures. When you buy a life company and after you do your due diligence, you get a chance to get in and bore down into what the company is really doing. Say you find out that the company has been selling bad life insurance policies for the last 15 years. The first thing you do is call up a lawyer. The second thing you do is call Chris DesRoschers. Off you go into the wonderful world of indemnification claims.

I tried to come from a fairly high level with this tax chapter. I wanted to have the reader thinking that this was a book that was oriented probably more than anything else to new actuaries, people coming into the industry and people who are not experts in life insurance or property/casualty insurance. The chapter was the view from 30,000 feet of how insurance companies are taxed differently from other types of corporations and how taxes play through mergers and acquisition activities in the insurance industry.

Transaction structuring is very tax-sensitive. On the subject of post-closing tax opportunities, how you structure a transaction can create issues. For example, if you do an asset purchase, amortization of some of the intangibles have a significant economic impact on the purchase price that you're going to pay for the company. You should be investigating tax issues. There is the 7702 issue I mentioned that you have to look carefully at if it's a life company, but also, just what is the tax posture of the company? How careful have they been with their tax positions? What exposure do they have to the Internal Revenue Service? These are the kinds of things that one looks at on tax due diligence.

Specialized rules apply to insurance companies. There are special rules for life insurance companies and for non-life insurance companies. When you go into an M&A transaction in the insurance industry, looking at things from the tax perspective, you have to understand that there are two different sets of rules with which one has to be familiar.

For life insurance companies, the focus in due diligence and tax planning is going to be on the life insurance reserves. For life insurance companies, there is what's known as the "surplus tax." For those of us who are old enough to remember, the Phase 3 taxes is another one. The surplus tax is the special tax on mutual insurance companies, but Section 809 is now in the process of being repealed. It's something that one needs to understand when one's looking at mutual insurance companies.

The deferred acquisition cost (DAC) tax is a component of the federal income tax, but it functions much like a premiums tax on life insurance, annuities and certain kinds of health insurance. It's a factor that one has to take into account when one's valuing a life insurance company, or a non-life company with life-type business.

For non-life companies, the focus will be on reserve deductions, which are actually provisions for losses and the unearned premium reserves. One spends a lot of time looking into these issues in valuing a company and then understanding what the future of the company is going to be after one completes the acquisition.

It's important to understand that there are special rules for consolidated returns. You cannot just freely buy a life insurance company and consolidate it. It's subject to the rules of life insurance companies that are newly acquired. If they're acquired by another life insurance company, there is the possibility of immediately filing a consolidated federal income tax return if you have nothing but life insurance companies in the chain of ownership. But if there are non-life companies either on the top or some place in the chain of ownership, there can be a five-year delay before one can file a life/non-life consolidated federal income tax return. This is an important thing to understand in planning acquisitions. You cannot necessarily freely consolidate a life insurance company.

By and large, non-life insurance companies are freely consolidatable unless you have a life insurance company throwing everything off. But if you buy a non-life insurance company into a group filing a consolidated return, they will automatically become a member of the consolidated group. But, again, the difference is the life insurance companies. Even after the five-year runs, there are limitations on using losses against life insurance income.

In the chapter, we go through the various forms of structuring issues and tax-free reorganizations. There are a number of different forms that are taxed for your organizations. This is something that one needs to understand in structuring an acquisition. We talked about taxable transactions. You have to go through an evaluation of a transaction. What is your after-tax cost? Is it better to do a stock purchase? Is it better to do an asset purchase? If you want to do an asset purchase in the insurance business, how do you do it? You do it through a reinsurance transaction. These are all going to have significant valuation issues in your structuring.

Something that was already mentioned was the Section 338(h)(10) election. There is a possibility of doing a stock acquisition, which is important sometimes for state law purposes, for liability purposes or for a variety of reasons. This is an election that allows you to treat it for tax purposes as an asset acquisition. That is a very important valuation concern.

The chapter goes into the loss limitations on the use of net operating losses or operation loss deductions, as it's called for life insurance companies. This is an important part of valuation of a target.

We also discuss due diligence issues and consolidated returns. If you buy a company that has been a member of a consolidated return, you have to understand that any member of a consolidated group is jointly and severally liable for the entire group tax all the years that it was a member of that consolidated group. This is something that one needs to understand when you buy a company out of a consolidated group.

MR. TOOLE: We have one final author with us today to talk about the purchase GAAP chapter. Ken LaSorella is vice president of U.S. GAAP of Sun Life Financial and has done an amazing job putting this chapter together. It's not a simple topic to deal with, and there is a surprising amount of latitude in currently accepted practices.

MR. KENNETH A. LASORELLA: First I will talk about my approach to being a wrangler, or at least my experience as a wrangler, and then about the accounting aspect. The chapter isn't just about actuarial issues and concepts. These are very practical accounting issues, including who has bought whom, which isn't all that easy to answer nowadays. It also looks at what the exact price is, especially if there are contingent considerations. The price might be contingent upon performance and so on. These are very practical issues and, again, the textbook is not just for actuaries who would want to get some exposure in the industry.

Purchase accounting is pretty much actuarial once we get beyond the assets, so we will have PGAAP liabilities or PGAAP reserves. We'll have intangibles, such as the value of business acquired (VOBA), and also some goodwill impairment testing. That's where the actuarial elements come in. Reinsurance and statutory accounting principles are all covered also, but the chapter is about 90 percent U.S. GAAP and a little bit of statutory.

On the accounting team, Erika Schmidt did most of the writing. Owen Ryan also worked with her. Alan Hines, who spoke already, contributed to every chapter in some way or another. If there were any elements that were unique to property/casualty, we asked Alan to write those pieces, whether it had to do with reserves or VOBA and so on, and then I wrote the other actuarial pieces.

Laird Zacheis did not actually write part of this chapter, but his exhibits and his contribution was invaluable because I essentially stole what he had written in Chapter 4 for the actuarial appraisal method. He was also good enough to provide some purchase GAAP projections off this same universal life example. So we have continuity from one chapter to another that way.

Now the editors, Tom Herget and Jim Toole, sat down with me and went through everything word-for-word in the chapter, including what the reviewers gave us. This highly qualified team of reviewers (Dave Rogers, Jim Hawke and Dan Kunesh) made invaluable suggestions, and we tried to incorporate their suggestions into the text.

Regarding personal experiences, I work for an insurance company, Sun Life Financial. Let me tell you what a pleasure it was to be able to ask some very esoteric questions of a panel of experts, experts in the field, and actually get answers. It was absolutely phenomenal.

My own personal motivation is that Sun Life went through two acquisitions right around the time that FAS 141 was being introduced. The problem is that there's no how-to. Show me a numerical example. Show me a calculation of VOBA. Give me some logic. Tell me what the theoretical background is or theoretical support. Even though it's not the only method in practice, at least it's one method. Let me tell you—there is no such animal.

The American Academy of Actuaries 1977, called Interpretation 1D, actually explained how you could calculate PGAAP liabilities, PGAAP reserves, define initial reserve method and define the valuation premium method. However, that's for old traditional products, and it didn't handle VOBA.

The best source for VOBA was a 1983 draft issues paper of the AICPA, which was excellent. It actually projected statutory book profits, U.S. GAAP profits and book profits, and discounted a different risk discount rate, which was terrific, except it was never issued in final form. Why? I have no idea. But had it been issued in final form, it still was before the proliferation of the FAS 97 account value products because we have variable universal life. We have deferred annuities, both fixed and variable, GICs, etc. Also, even more important, it was before required capital, before risk-based capital (RBC) or minimum continuing capital and surplus requirements (MCCSR). So it couldn't answer a question of whether or not you should include the cost of capital. I want to tell you that three years ago, only a short time ago, we had arguments with one major accounting firm regarding reflecting the cost of capital. It wasn't that clear. Today, everybody says, "Oh, yes, reflect the cost of capital." I was just looking for a how-to.

By taking Laird's actuarial appraisal method along with embedded value, which certainly does reflect cost of capital, and looking at finance theory and looking at practice, we could actually have one method, say a version of the actuarial appraisal method. Even though that's not the only method, you may disagree with that. In practice you'll see a variety of methods. At least it's one method that you could follow that an actuarial student could say, "Here's the calculation and I could produce a number." That was the main objective there.
Then the constant challenge is to always make sure that what we're doing reconciles with fair value, because FAS 141 and 142 want fair value. Just to give you a lightning fast example, if we have a purchase GAAP liability with, say, a reserve equal to an account value of $1,000, and we have a VOBA of $100, we're saying that the account value minus the VOBA, or the net GAAP liability, represents fair value. If that $1,000 were converted to $900 and already was a fair value liability, there would be no need for a VOBA. It was also important to recognize that there are diverse current practices, because we didn't want to push one method and say that that's the only method. Otherwise, all these audit firms that have already approved purchase accounting would sort of be in hot water and we don't want to see that.

MR. TOOLE: The final chapter in the book is integration, but we're going to skip over that because our author is not here. We will go directly into one of the other real added-value features of this book. In addition to the writing of the experts and all the examples, we have actual contributions from practitioners in the field. We probably have 60 of these, which we're calling "crypts." It was Tom Herget's idea to bring this to the table, and he made this value-added feature happen.

MR. HERGET: You'll see throughout the book "Tales from the Crypt," also called war stories. In order to illustrate the points that are made in the book, we needed real-life examples. While the text is factual, straightforward and flows well, we've interjected some stories throughout the book. You will read some interesting tales about discount rate selection and goodwill, or ill-will. We've got 60 to 65 stories dispersed throughout the book, all provided by practitioners. We solicited 100 people, but some were reluctant to share. Some were concerned that they could be identified, but I tried to get the stories anyway.

Here's a sample: "In making acquisitions over the years, we've tried our best to get quality assets to back the liabilities. Cash is always best. Investment-grade bonds are fine and good-quality mortgages are acceptable. When you're buying a company, or taking over a block of business in receivership, sometimes you get assets that are not as desirable. But one time we got a cemetery."

Another is entitled "Mobeus Deadline." You're familiar with that Mobeus strip that wraps around and really only has one side. This is a two-sentence crypt: "One week, we worked day and night to value a life insurer. We were trying to meet a deadline that had already passed before we were hired." This M&A team had been hired *after* the due date.

Some are pretty humorous; some are more serious. One is called "The Road not Taken." I'll read you a paragraph. This was contributed by a corporate M&A actuary who is no longer in that field. "When someone is hot to trot to make an acquisition and your price is so far from that of a leading bidder, your analysis is questioned. It's sometimes tough to stand up enough for your belief in your work to keep a silly bid from being submitted. When I say tough, I don't mean that personal character strength is an issue. But when you look at the fact that you are going up against so many others at once, you almost need to have a legal power of persuasion as well as financial analytical skills. But prevailing in these arguments is well worth it in the long run. However, five years later, when that winning bidder goes bankrupt, you don't get the call from your co-workers saying you were right."

There are all kinds of interesting stories from practitioners that you'll find very enjoyable and enlightening in reading.

MR. TOOLE: Where we are in the final process? All of the chapters were peer reviewed by three or more external practitioners. They went through a professional editing and final editorial review, as well as layout and indexing processes. In addition, to the extent possible, we've included a bibliography of sources from the SOA and Casualty Actuarial Society (CAS) libraries. We think it's a very value-added thing. There are large blocks of information, which are intellectual assets that many people don't know exist. We've taken many recorded sessions that have a lot of good information but are not published anywhere other than on the SOA Web site, and we have put them in the books alongside our exam syllabus, other textbooks and other sources of information that went into our bibliographies.

Finally, on the subject of marketing, we have a new marketing arrangement. We get a 15 percent discount on John Wiley books. They're going to take our textbooks and sell them to other professions. We're looking at 500 pages, more or less. We had more than 100 contributors. We had a big budget, and we're projecting quite a few sales because we're trying to push it into other markets. It will be available in the second quarter of 2005.