Document generated on 01/06/2025 11:29 p.m.

Assurances

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Volume 66, Number 2, 1998

L'AVENIR DU SECTEUR DES SERVICES FINANCIERS CANADIEN
THE FUTURE OF THE CANADIAN FINANCIAL SERVICES SECTOR

URI: https://id.erudit.org/iderudit/1105208ar
DOI: https://doi.org/10.7202/1105208ar

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Publisher(s)

HEC Montréal

ISSN

0004-6027 (print)
2817-3465 (digital)

Explore this journal

Cite this article

Abdalyan, A. (1998). TRANSACTIONS IN THE INSURANCE INDUSTRY: A ROAD-MAP. *Assurances*, *66*(2), 277–284. https://doi.org/10.7202/1105208ar

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TRANSACTIONS IN THE INSURANCE INDUSTRY: A ROAD-MAP

Ani M. Abdalyan

ABSTRACT

The purpose of this article is to provide a road-map to mergers and acquisitions in the insurance industry. The author will set out the ins-and-outs of the documentation of a transaction. Where appropriate, she will sketch some business opportunities and concerns tied in to drafting of the documentation. Finally, she will offer some concluding thoughts on post-mergers management of integration.

RÉSUMÉ

Le but de cet article est de fournir une carte routière en ce qui a trait aux fusions et aux acquisitions dans l'industrie de l'assurance. L'auteure dégagera d'abord les pour et les contre dans la documentation pertinente entourant une transaction. Puis, dans les cas jugés utiles, elle esquissera certaines opportunités et intérêts commerciaux liés à la proposition documentaire. Finalement, elle livrera quelques réflexions finales relativement à la gestion de l'intégration postérieurement à la fusion.

The author :

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■ BACKGROUND

The insurance industry is a consolidating industry as insurance companies seek to adjust to economic, regulatory, technological and other forces. The motivational factor behind most merger and acquisition transactions is the desire to create long-term competitive advantage for the merged company. The reasons for mergers and acquisitions of insurance companies are usually not disclosed by regulators, managers or the media.

Strategic linkages can provide options for growth and flexibility. Through the consolidation, the merged company can have new avenues to pursue emerging markets. The merged company can also use its assets more flexibly in future transactions. A merger may also be a viable alternative to an insurance company insolvency.

It does not appear that there will be a slow-down in mergers and acquisitions activity in the insurance industry, both continentally and globally.

The purpose of this article is to provide a road-map to mergers and acquisitions in the insurance industry. I will set out the ins-and-outs of the documentation of a transaction. Where appropriate, I will sketch some business opportunities and concerns tied in to the drafting of the documentation. Finally, I will offer some concluding thoughts on post-merger management of integration.

■ STRUCTURING AND PLANNING THE TRANSACTION

□ Confidentiality Agreement: Inherent Tension

One of the first documents that is usually signed in order to proceed with a proposed transaction is the confidentiality agreement. There is an inherent tension in the drafting of the document because the buyer wants to have access to as much information as possible and the seller, especially when dealing with a competitor, wants to provide as little information as possible and still get a high price.

A confidentiality agreement is intended to limit the use of information to the proposed transaction, with the result that the information, which will only be made available to "key" people,

cannot be used for other purposes. The agreement will bind directors, officers, employees and advisors to the transaction. If the parties decide not to proceed with the transaction, all information must be returned or destroyed. It is possible to request a certificate of destruction to indicate the destruction of all documents.

The confidentiality agreement will also contain a provision prohibiting public disclosure of the existence or content of any discussions regarding the proposed transaction. The agreement will also set out limited circumstances where information can be disclosed to third parties e.g. regulators.

☐ Letter of Intent: Momentum

The letter of intent is a preliminary document which will generally be required before an agreement is drafted setting forth the details of the transaction. It will identify issues and set out the essential terms of the proposed transaction.

The letter of intent is generally not drafted by lawyers. Chances are that by the time a letter of intent is being drafted, some talking has occurred between the parties to the transaction. In practical terms, the letter of intent creates a framework for future business negotiations. As an "agreement in principle", it indicates the intention of the parties. At a minimum, the letter of intent creates a moral commitment between the buyer and the seller to work together to complete the transaction. The signing of the letter of intent can create momentum.

The style and content of a letter of intent will vary depending on the complexity of the transaction. A letter of intent may contain binding and non-binding provisions.

Non-binding provisions will likely deal with (a) price, time and manner of payment, (b) structure of the transaction, and (c) completion of due diligence, negotiating an agreement, obtaining financing, consent of third parties, agreement on an escrow and indemnity provision, conditions to closing and delivery of documents at closing.

Binding provisions will likely deal with (a) termination of the letter of intent at a certain future date, (b) seller granting access so buyer can do due diligence investigations, (c) seller not attempting to obtain a better offer for some time, and (d) non-competition.

Generally, the letter of intent is an attempt to set out what the parties want to achieve and is a non-binding document. Unless the

parties have indicated otherwise, Canadian courts could find a letter of intent to be binding if it includes material provisions of the agreement. As a result, in order to prevent this useful negotiating tool from becoming a binding contract, the best strategy is to include in the letter of intent a clearly drafted disclaimer which provides that the buyer and seller do not intend to be bound.

Furthermore, the parties' behaviour throughout the acquisition should be in conformity with the disclaimer in the letter of intent.

□ Escrow Agreement: Post-Contractual Claims

The escrow agreement is another vital document commonly used in structuring and planning the transaction. The purpose of the escrow agreement is to make funds available to the buyer in the event it has a post-closing claim, under the purchase agreement, against the seller because of inherent uncertainties involved in a transaction. Generally, a portion of the purchase price is deposited with a deposit-taking institution to ensure security of the funds. An escrow agreement must be clear and precise as to when and how funds for the transaction will be released.

□ Indemnity Agreement: Limitation of Liability

An indemnity agreement will generally accompany a letter of intent. Basically, an indemnity agreement has the potential for liability imposition or shifting. It provides reassurance to the assumption of a certain risk by one of the parties to the transaction.

An indemnity agreement may provide that the seller will indemnify the buyer against all liability, arising from the failures of representations or warranties, or that it will provide the usual and customary indemnification. From the perspective of the buyer, the broad "usual and customary" indemnity is preferable because it enables the buyer to request broad and extreme indemnities.

■ DUE DILIGENCE

□ Assessing Value

Once the commitment letter is in place, in modern mergers and acquisitions the next step is technical due diligence. With long-checklists and thorough investigation e.g. by teams, of the target

company before the closing of the transaction, due diligence has traditionally been used to find legal and technical flaws and weak spots in the target. During due diligence, the buyer can also obtain a historical understanding regarding the target by interviewing employees and customers.

Due diligence, however, does not have to be reactive. It can be an opportunity for the buyer to find new solutions not perceived by others. The buyer should do its research and homework. It should go the "extra mile".

Due diligence provides an opportunity to the buyer to objectively evaluate the target's strengths and weaknesses, and to investigate whether the target is really the company it wants to buy. The buyer can compare its characteristic qualities with those of the target. To what extent will the acquisition enhance the buyer's position in the marketplace?

The buyer will want to analyze the target's products, customer-base, know-how, market share, technology and how these factors will result in a successful transaction that creates shareholder value. As insurance markets become increasingly national and international in scope, the buyer may also want to specifically analyze the extent to which the technological assets of the seller will add value to the transaction.

Due diligence may reveal some deal-breakers including pensions, retirement benefits and environmental exposures.

Time, money and efforts in getting to know the target company will be well-spent. The buyer should determine whether the acquisition of the target will result in efficiency gains and shareholder value-creation. Where the parties do decide to move forward with the transaction, due diligence will address structuring issues and will result in setting out terms in the purchase agreement that will protect both parties.

THE AGREEMENT

Every purchase agreement will have an architecture which meets the needs of the specific transaction. Drafting the document will involve shaping solutions to conceptual problems so that the agreement works in the real world. The final document must be free from internal inconsistencies.

Most agreements governing merger and acquisition transactions tend to be quite lengthy. The aim of this part of this article is to set out adaptable models of some key matters that will typically be covered in the agreement.

Terms of the Agreement

Confidentiality

Confidentiality is essential for the performance of any agreement. Possible considerations regarding provisions dealing with confidentiality will range from no unauthorized disclosure to no unauthorized use. There may also be a clause which provides that confidentiality will survive any execution, termination or expiration of the agreement.

Non-Competition

It is general practice to insert a clause which prohibits competition, directly or indirectly, and is reasonable in terms of time and geographic limitation. A non-competition provision will be especially significant where an insurance company sells off its books of business and remains in run-off.

Alternate Dispute Resolution

Before inserting a clause dealing with alternate dispute resolution as an alternative to court proceedings, the buyer and seller should consider whether the mechanism suits their real purposes. Some reasons to chose alternate dispute resolution include application of special expertise, informality, confidentiality of process, lower overall costs and speed of adjudication.

The use of alternate dispute resolution is preferable when there is a genuine potential for settlement. Where the parties view the resolution of the issue, rather than the desire to set precedent, as being paramount they should also consider the use of alternate dispute resolution.

Warranties and Representations: Risk management

Every purchase agreement will contain a section dealing with representations and warranties which must be given by the parties to the transaction. Representations and warranties are a tool to manage risk.

The scope and complexity of representations and warranties will depend on the particular facts of each proposed transaction including the identity of the buyer and seller and the regulatory environment of the company.

The object of representations and warranties is to provide true statements of fact on relevant issues which exist at the date of execution of the agreement. If a party cannot give the exact warranty requested, it is possible to use limits as to materiality or reasonableness.

If a party is not willing to give a representation and warranty because he does not have the requisite knowledge, the party should give an indemnity in relation to the particular risk addressed by the representation and warranty.

The duration of representations and warranties should be specifically addressed and it is prudent to insert a clause which provides that the representations and warranties will survive the closing of the transaction.

☐ Indemnities: Limitation of Liability

Every purchase agreement will contain a section dealing with indemnities which will set out how an innocent party will be indemnified against possible costs and expenses arising from breach of representations and warranties under the purchase agreement. Indemnity provisions may also relate to third parties.

Some basic matters which will generally be covered in indemnities include parties, sources of loss, monetary limitations, term and procedural matters. It is crucial that the indemnity be drafted with precision.

■ POST-MERGER INTEGRATION

No matter what the motivational factor is in an acquisition in the insurance industry, right after the purchase agreement is executed and the transaction is completed, the acquiring company may experience "merger syndrome". It may find itself in a state of aimlessness and indecisiveness. There may be conflicts, resistance to change, culture clashes and low employee morale in mergers and acquisitions.

The completion of the transaction is only the beginning. Turning two insurance companies into one is a difficult and complex process. Any acquisition takes time to absorb. It is vital to manage the operational, procedural and cultural integration effectively. Smooth and decisive integration as well as executive focus on success factors including resolution of differences and adapting to new routines and knowledge bases will result in improved efficiency.