TS insights

Collateral damage: hidden deal breakers in insurance

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Foreword

Collateral provided to insurers must be understood and managed

Insurance collateral may not be the first thing dealmakers think of when they evaluate an acquisition candidate. However, insurance collateral provided to insurers by most companies with large deductible or similar insurance programs can be painful for an acquirer if it is overlooked or misunderstood. Collateral requirement increases over time can reduce a company's borrowing capacity. Unanticipated increases are a nasty surprise to acquirers' — especially private equity since private equity deals typically rely on debt financing. Potential limits on borrowing should be uncovered early in the diligence process. The diligence team should explore strategies for lowering future collateral requirements after the deal closes and sponsors should make sure that company management regards insurance collateral as a priority. Given the difficulties in securing financing, it pays to be aggressive in managing collateral provided to insurers.

Background

Insurance companies require collateral to cover an insured's liability should the insured (i.e. the company) not pay their obligation or become unable to reimburse the insurer for losses the insurer has paid on the insured's behalf under Workers Compensation and Auto Liability loss-sensitive insurance programs, i.e. deductibles, and self-insured loss retentions. Insurers may also require collateral loss sensitive plans for other types of insurance such as general and professional liability.

States will require collateral for qualified self-insurance plans. Insurers often require collateral if the insurers are re-insured by the insured's captive insurance subsidiary.

The most common forms of collateral provided by companies to insurers are letters-of-credit (LOCs), cash, surety bonds and trusts.

Insurers use collateral to not only manage credit risk but also to preserve their statutory surplus levels. Insurers maintain levels of statutory surplus (the

amount of assets exceeding liabilities) to meet individual state guidelines. While insurers may post receivables from insureds with loss sensitive programs, statutory insurance accounting rules do not recognize these receivables unless they are suitably collateralized. The insurance company is faced with a very simple choice, reduce their surplus or require collateral.

To reduce exposure to credit risk, insurers take a very conservative approach to collateral and typically require a highly leveraged company to post more collateral than a company with a stronger balance sheet, even if the expected losses are identical.

What to look for during diligence

Given the impact collateral obligations can have on an acquisition candidate's post-deal borrowing capacity, dealmakers should perform key areas of collateral analysis, such as the type and reasonability of the amount of collateral provided as well as whether or not collateral will be required of the acquired company post-sale for pre-close liabilities in a divestiture or carve-out .

Collateral obligations under qualified self-insurance plans should be evaluated.

The following steps should be taken when reviewing collateral:

Identify the forms of collateral

- Letter-of-credit (LOC) is, from an insurer's perspective, the most desired form of collateral. Thus, LOC is the most common collateral form.
- Cash is often used in escrow accounts, but significant obligations are rarely collateralized in cash due to insurer concerns on accessing the cash after the insured files for bankruptcy.
- Surety bonds, which are often collateralized by a LOC, are used mainly for qualified self-insured programs.
- Irrevocable trusts, with the insurer as the beneficiary, must hold acceptable assets, such as cash, cash equivalents, commercial/treasury bonds and equities.

Collateral analysis

- *Identify which types of insurance are secured by the collateral:* Typically, companies must post collateral to cover workers' compensation and auto liability loss sensitive programs; but insurance carriers may also require collateral for general/product and professional liability loss sensitive programs.
- *Qualified self-insurance:* Many companies may become qualified by individual states as self-insurers for workers' compensation and auto liability. Often, state's collateral obligations are satisfied by surety bonds. Surety bonds are frequently collateralized by LOC. Many states calculate workers' compensation obligations differently than insurance companies which often results in less collateral than required by an insurer. In a highly leveraged situation, it is likely the surety company may require additional collateral and, in the worst case scenario, the state may disqualify the company from self-insuring new losses, and the company would need to enter a traditional loss sensitive program with an insurance company, invariably with greater collateral requirements.
- *Identify the collateral coverage period:* Since collateral is normally provided at the beginning of a policy period, the time frame the existing collateral covers should be understood. Policy terms are typically set for twelve months, with collateral usually secured for the entire period and posted at the policy inception. If the target company is midway through its term, the existing collateral will not be sufficient for the full fiscal year, and additional collateral will be required. Buyers need to estimate the full year and subsequent requirements.
- *Review credit penalties or discounts:* These can modify the entire collateral obligation upwards or downwards. Some collateral agreements have change-in-control and/or financial performance triggers which need to be understood and applied to go-forward analysis.
- *Evaluate the insurer's collateral adjustments:* Diligence should clarify whether the carrier has amended collateral obligations in a timely fashion to reflect payments or closure of claims. Multiple historical insurers holding collateral may be an opportunity to reduce collateral, since the company's efforts may be more focused on dealing with collateral held by the incumbent insurer.

- *Scrutinize the insurer's calculation of collateral:* Insurance companies typically use actuarial methods to estimate the ultimate unpaid value of claims under their coverage period, taking into account the insured's loss history and financial strength, along with the length of its relationship with the insurance company. It is in the insurers' best interest to be conservative; therefore, their loss estimates may be higher than those of the insured. During diligence, the acquirer should compare the collateral requirements against their own actuarial calculations to understand the reasonability of the requirement. If the acquirer believes there is an opportunity to reduce collateral, post-close, the acquirer should encourage the company to review the collateral obligations with the insurer in an effort to achieve reductions.

Collateral held by insolvent insurers

- Achieving reduction or elimination of collateral held by an insolvent insurance carrier is difficult. While one would expect a legacy insurer, who provided coverage years ago, to annually reduce the collateral held to reflect claims payments, such reductions from an insolvent insurer often occur slowly. If substantial collateral is held by an insolvent insurer, the acquirer should be realistic in estimating collateral adjustments from insolvent insures.

Carve-out and NewCo issues

- In a carve-out, the selling parent company usually controls the insurance relationship and is generally responsible for supplying collateral. Even when a subsidiary is sold and historical liabilities transferred to the Newco, the insurance relationship and the contractual obligation to provide collateral is generally still between the parent company and the insurance carrier. Thus, current collateral obligations remain the responsibility of the parent. Buyers need to be certain to avoid inadvertently assuming these collateral obligations in the purchase agreement.

  Going forward, the Newco must post its own collateral for loss sensitive programs. Collateral requirements will be influenced by Newco's credit worthiness, which may be more leveraged than its parent.

Working capital considerations

- Diligence should detect whether any current assets are in fact cash or cash equivalent collateral and whether such assets should be considered restricted under the purchase agreement. Cash or cash equivalent assets provided as collateral may be an opportunity for the buyer to substitute a LOC, post close, for the cash/cash equivalent.

Strategies for reducing collateral requirements

After acquiring a target, there are several ways for dealmakers to reduce and manage collateral requirements for loss sensitive programs once a deal closes. While there is no "silver bullet" from a company's perspective, some commonly used strategies include:

- Achieving qualified self-insured status for workers' compensation when possible. Setting up qualified self insurance for workers' compensation will not avoid collateral requirements since most states require collateral which are often satisfied by surety bonds. However, the collateral build may be lower than traditional insured loss sensitive plans. If collateral can be satisfied by surety bonds, there is a benefit if the collateral supporting the surety bond is less than 100 percent of the surety bond. One possible administrative issue is the company would need to deal with multiple security holders (the states) instead of an insurer.

- Be your own advocate in collateral negotiations. Collateral obligations are often the last detail set forth by an insurer in an insurance renewal. Collateral can become the most contentious issue, not simply because of the amount, but also because of the timing of the insurer's disclosure of the requirement. Attempting to resolve collateral issues on the eve of an insurance renewal is often fruitless and makes the insured believe they have been painted into a corner. Push hard for the collateral numbers early in the renewal process (ideally, get this in the contract with the insurer) and actuarially calculate your own collateral needs. Since it often becomes a negotiation, companies should have their arguments in hand before receiving the news from the underwriter. Building relationships with the insurer's credit department, as well as your insurance underwriter, is important since the credit

department sets collateral requirements. Presentations to underwriters and credit departments which provide details on a company's financial state can have a positive impact during collateral negotiations. As part of these negotiations, policyholders should present their own estimates of how collateral will grow or diminish over time, since insurers often use their own or general industry information that may not reflect the realities of the policyholder's situation. Timing is critical. Dialogue on collateral should be held well in advance of policy renewal.

- Establishing parameters of collateral requirements. Before you, as the company, enter into a relationship with a new insurer, you should formalize the parameters of the insurer's collateral administration, i.e.: the timing of adjustments, the insurer's documentation supporting the insurer's collateral calculation and credits for anticipated paid losses.

- Aggregating or limiting deductibles to reduce the obligations of requiring security. While this entails cash and expense trade-offs, it is a natural way to reduce collateral obligations.

- Reducing the time required to settle claims through a more intense, systematically directed claims management process. This process ensures claims are closed as soon as practicable, and reduces the company's ultimate loss estimate and thus its collateral obligation. Key to this strategy is an insurer who will provide timely collateral credit. There are two principal ways to achieve earlier claims dispositions. One is to pragmatically triage the claims into three 'buckets', those which are resolvable for reasonable sums, claims which for business and liability reasons must be defended and claims which can't be settled short of the courthouse steps. This procedural change should be differentiated from accelerated claims closure initiates. The trade off of accelerated claims closure is cash outlays for settlements to spike over historical cash payouts. Another is to be sure the zeal to settle cases does not increase the settlement values of claims.

- Aggressively attacking loss prevention and control. Every dollar or claims avoided due to enhancing claims management and safety approaches will ultimately reduce collateral requirements.

- Establishing a self-insured retention on general liability. The insurance carrier's contractual obligation would commence only after the retention limit is reached. The collateral requirement is reduced by the size of the retention fund.

- Using short-term policies is a means to delay the provision of new collateral. For example, some insurers will issue distressed companies a six month policy, which would reduce the collateral requirement to the six month policy term. Naturally, the amount can be more than half, but it may be useful to a company with constrained borrowing capacity.

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Analyzing an acquisition candidate's collateral obligations and identifying strategies for reducing them should be a key component of due diligence, especially if the target has high debt levels or the buyer plans to finance a significant portion of the transaction with debt. Collateral requirements that increase over time can constrain the target's borrowing capacity, thereby limiting access to a key source of growth capital.

Private equity firms should not hesitate to challenge their portfolio companies to aggressively reduce LOC amounts held by current and historical insurers as well as to reduce the origin of collateral requirements, retained losses.

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