Assessing the risk of M&A: Bruner’s Disaster Framework applied to Berkshire Hathaway’s Gen Re Acquisition

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M&A is widely considered to be risky, and yet Robert Bruner’s Deals from Hell – M&A Lessons that Rise Above the Ashes (NY: Wiley, 2005) is likely the first book that attempts to systematically study and frame the root causes and risks of M&A failure.[1] Taking an innovative approach, Bruner realized that the types of initial misunderstandings, mistakes and miscalculations that are revealed after many notorious disastrous events occur can also be observed after management misadventures like failed acquisitions. To construct his innovative disaster analysis framework Bruner, a professor of finance at the University of Virginia whose academic specialty is M&A, first studied the causes of a variety of catastrophes such as:

- The collapse of the Walkway at the Kansas City Hyatt Regency Hotel in July of 1981.
- Chernobyl in April of 1986.
- Bhopal in December of 1984, and its follow up.
- Ocean Ranger in February of 1982.
- A Mount Everest expedition in May of 1996.[2]

Bruner makes the case that the same types of bad decision making that caused these five disasters could also produce strategic misjudgments, such as a poorly conceived M&A deal. He concludes that a model for causal analysis of disastrous occurrences like these also can be used to assess M&A-related risk, as well as the risk of other ambitious strategic initiatives.

Bruner’s disaster analysis framework is composed of six factors that a corporate leader could use to better assess M&A risk:

1. Complexity – something in the business or deal that makes it difficult to understand and value.
2. Tight coupling – limited-to-no flexibility is available to absorb “the effect of miscalculations or worse than average luck,” to borrow a phrase from the late financier Benjamin Graham.[3]
3. Business not as usual – turbulence in the business environment produces or contributes to errors.
4. Cognitive biases – for example, over-optimism.
5. Adverse management choices – unintended consequences that increase the risk of a deal.
6. Operational team flaws – arising from cultural differences, lack of candor, political infighting, and aberrant leadership.[4]
Bruner observed that none of these factors alone will likely result in a disaster, but risk soars if most or all of these factors are present. "The convergence of disaster causes is, I think, the most important foundation required of the thoughtful practitioner for understanding M&A failures, or for that matter, all business failures."[5]

To demonstrate how this framework could be used in M&A, Bruner applied each of the above factors to a number of insightful case studies such as Sony's 1989 acquisition of Columbia Pictures, AT&T's 1991 acquisition of NCR and AOL's 2001 merger with Time Warner. He closes the case section of his book by contrasting Tyco's relatively unsuccessful M&A program under former CEO L. Dennis Kozlowski with the generally successful M&A program of Berkshire Hathaway Chairman and CEO Warren Buffett.[6]

The business press has extensively reported on Buffett's acquisitions, including a number of notable successes such as the 1995 GEICO acquisition. (Recently, this journal published a formal retrospective study of that case.[7]) Buffett has not, however, been immune to the occasional "Deal from Hell." One such deal was the 1998 acquisition of the General Reinsurance Corporation (Gen Re). This analysis will apply Bruner's framework to the Gen Re case to discover whether it helps to assess the relative risk of failure of that acquisition.[8]

The Gen Re acquisition

Gen Re's business is "reinsurance," which is insurance for insurance companies. For example, many insurance companies insure homes for a variety of perils such as rain, wind, fire, and flood. As the volume of homes insured increases, insurance companies are at risk of a catastrophic loss from a single hurricane, tornado or other natural disaster. To manage this risk, some insurance companies routinely contract with reinsurance companies to transfer part of a loss.

1. Complexity

Complexity is a characteristic of the reinsurance business. For one reason, consider the time lag (in industry parlance, the "tail") between when insurance events occur and when the claims of those events are reported to a reinsurance company. The tail of a hurricane, for example, is relatively short because homeowners tend to file hurricane-related claims very quickly and, in turn, insurance companies report such claims to their reinsurers quickly. Conversely, the tail for certain casualty-related claims can be very lengthy. Consider asbestos claims, which in some cases are first reported to insurance companies, and hence reinsurance companies, decades after exposure to asbestos. Claims' reporting is delayed because the injury caused by asbestos may not immediately manifest itself. While asbestos liability is an extreme example, it does convey the complexity inherent in reinsurance company valuation.

2. Tight coupling

Perhaps the most significant cause of tight coupling is paying too much for an acquisition. High prices reduce the flexibility that an acquirer has to absorb the effects of "worse than average luck" that may arise. One measure of paying too much in a deal is the price-to-book ratio (P/B): generally, lower P/B deals provide greater flexibility while higher P/B deals could reflect tightly coupling. Applying this measure to the Gen Re acquisition, we note that Buffett purchased the firm for $22 billion, which was nearly three times Gen Re's book value of $8 billion. This premium over book does not in and of itself reflect overpayment, but it was likely
based on significant assumptions regarding Gen Re’s intangible assets, which means it was risky (or prone to loss). As it turned out, that risk did manifest as Gen Re’s losses (profiled in Exhibit 1) accumulated.

The significant loss sustained in 2001 was caused, in part, by the tragic September 11th terrorist attacks, which Buffett himself observed would have threatened Gen Re’s ability to remain a going concern had it not been acquired.[9] While such a loss could not have been foreseen beforehand, the high P/B of this deal afforded no flexibility whatsoever to absorb “the effect of miscalculations or worse than average luck.” In short, this deal was tightly coupled.

3. Business is not as usual

Bruner’s third risk factor is that business is not as usual, and in the insurance business the September 11th attacks on the World Trade Center is an obvious example. For the Gen Re case, however, business was unusual in 1998 for another reason: the “new economy” boom.

The “new economy” is predominantly associated with technology-related firms, which Warren Buffett generally avoided. However, the speculative buying that characterized the “new economy” was far broader than the technology sector, and I would argue that it was to some extent a factor in the Gen Re acquisition. For example, that deal was structured as a stock exchange: Gen Re shareholders had the option of accepting either 0.0035 Class A Berkshire Hathaway shares or 0.105 Class B Berkshire Hathaway shares for each of their shares.[10] This structure is noteworthy because the majority of Buffett’s acquisitions are made with cash, not stock. However, in the late 1990s stock-based acquisitions were extremely popular due to “new economy” generated momentum.

4. Cognitive biases

Bruner’s fourth factor, identifying and analyzing cognitive biases, such as over-optimism, can be extremely difficult.[11] To help demonstrate cognitive bias in M&A, Bruner

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**Exhibit 1** Gen Re’s pre-tax earnings post acquisition 1998-2007

<table>
<thead>
<tr>
<th>Year</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss</td>
<td>-26</td>
<td>-1,184</td>
<td>1,254</td>
<td>145</td>
<td>3</td>
<td>526</td>
<td>555</td>
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**Notes:** Data sources: 1998 – 2007 Berkshire Hathaway Annual Reports. Dollars in millions. The results appropriately exclude investment income as that income is generated by Buffett, not by Gen Re. Note that the insurance and reinsurance industries experienced near record levels of profitability in 2006 and 2007 due, in part, to the relative lack of catastrophes.
constructed a table that listed: (1) CEOs’ words about their respective deals at announcement, (2) the financial loss incurred in the deals, and (3) CEOs’ words when the M&A failure had been acknowledged (denoted “at the end”). I present a similar table in Exhibit 2 for the Gen Re acquisition without reference to the financial loss (which is illustrated in Exhibit 1).

Additionally, the 1998 Gen Re acquisition followed the very successful 1995 GEICO acquisition, which occurred at a premium of 25.6 percent over GEICO’s stock price at the time. Subsequent events with GEICO dramatically demonstrated the value that could be created in an insurance franchise-based acquisition,[12] which likely served to support the logic of, and confidence for, the Gen Re deal.

5. Adverse management choices

In the Gen Re acquisition, perhaps the most significant of Brunner’s risk factors was adverse management choices. As Gen Re’s performance deteriorated Buffett appropriately replaced the Gen Re CEO, Ronald Ferguson. Clearly, given the results illustrated in Exhibit 1 a

<table>
<thead>
<tr>
<th>Exhibit 2</th>
<th>Warren Buffett’s comments on the Gen Re acquisition</th>
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<tbody>
<tr>
<td><strong>At the announcement (1998)</strong></td>
<td><strong>At the end (2007)</strong></td>
</tr>
<tr>
<td>“But the main attraction of the merger is synergy, a word that heretofore has never been used in listing the reasons for a Berkshire acquisition. In this transaction, however, there are at least four areas of powerful synergy, which ... justify the premium price that Berkshire is paying. “First, this transaction removes constraints on earnings volatility that have caused General Re, in the past, to decline certain attractive business and, in other cases, to lay off substantial amounts of the business that it does write. Because of both its status as a public company and its desire to maintain its AAA credit rating, General Re has, understandably, been unable to operate in a manner that could produce large swings in reported earnings. As part of Berkshire, this constraint will disappear, which will enhance both General Re’s long-term profitability and its ability to write more business ... “Second, General Re has substantial opportunities to develop its global reinsurance franchise. As part of Berkshire, General Re will be able to make investments to grow its international business as quickly as it sees fit. “Additionally, General Re will gain tax flexibility as a result of the merger. . . . “Finally, Berkshire’s insurance subsidiaries never need to worry about having abundant capital . . . “These synergies will be coupled with General Re’s pristine worldwide reputation, long-standing client relationships and powerful underwriting, risk management and distribution capabilities. This combination virtually assures both Berkshire and General Re shareholders that they will have a better future than if the two companies operated separately”</td>
<td></td>
</tr>
<tr>
<td>“For decades, General Re was the Tiffany of reinsurers, admired by all for its underwriting skills and discipline. This reputation, unfortunately, outlived its factual underpinnings, a flaw that I completely missed when I made the decision in 1998 to merge with General Re. The General Re of 1998 was not operated as the General Re of 1968 or 1978”</td>
<td></td>
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</tbody>
</table>

management change was warranted. However, Buffett replaced Ferguson with Gen Re’s then CFO, Joseph Brandon, who had worked closely with Ferguson and who was considered Ferguson’s heir apparent. Additionally, Ferguson was retained by Gen Re as a consultant after his dismissal as CEO. These management decisions generated a series of unintended consequences.

In 2000, Ferguson in his capacity as a consultant with Gen Re facilitated a $500 million “finite risk” reinsurance deal with insurer AIG that went incredibly wrong. Finite risk is an inherently complex reinsurance product; a practical way of defining it is presented below:

While this custom-tailored contract [finite risk] can take many forms, it commonly involves a limited period and a very large premium. An insurer, such as reinsurer General Re, writes a finite policy for a corporate client or another insurance company that covers potential claims up to a set limit. Over a given period, such as three years, the client pays premiums that altogether come close to the maximum coverage. If there has been no claim by the end of this period, the insurer returns all or most of the premium to the client.

The insurer receives a fee and, since the premiums are so large, does not risk severe loss. By paying such large premiums, the client effectively bears nearly all the cost of a catastrophic event by itself. But by spreading the premiums over several years, the client avoids taking the hit all at once. Hence, finite insurance can be used to smooth out the client’s financial results.[13]

As the sub-prime home mortgage loan debacle has recently reminded us, financial innovations designed to manage or mitigate the risk of problematic financial products must be treated with extreme care. With respect to the Gen Re – AIG finite risk contract, government investigators alleged that its motivation was to artificially inflate AIG’s reserves by $500 million to satisfy financial analyst concerns about a possible reserve shortfall in that amount. They have also alleged that the Gen Re – AIG finite contract did not involve risk transfer; in short, it was a loan, but it was accounted for as reinsurance and therefore constituted fraud.[14]

Criminal charges were brought against Ferguson, as well as Gen Re’s former CFO (Elizabeth Monrad), former Associate General Counsel, and AIG’s former Reinsurance Chief. After a lengthy trial all were found guilty of the charges brought against them.[15] Shortly after the verdict, Gen Re CEO Brandon resigned. According to a newspaper account of the resignation, “Federal prosecutors have been pressing Berkshire to replace Mr. Brandon following fraud convictions of four former General Re executives earlier this year….. His removal was seen as part of an effort to conclude the government’s investigation into General Re.”[16] While Brandon was not charged criminally, he was the recipient of a “Wells Notice” (which is a letter from the SEC to those it is planning to bring an enforcement action against) and thus was considered a likely target of future legal action.[17]

 Needless to say, all the legal activity arising out of this finite risk contract generated legal fees, which were likely substantial and which may not be reflected in the financial loss data presented in Exhibit 1. If not, the total financial loss of this acquisition would have to be increased by those costs. It would also have to be increased by the value of the time spent on this matter at the expense of other, potentially more value creating matters (economists refer to this value as “opportunity cost”). This cost is also likely substantial, especially with respect to Warren Buffett’s time. All because a former CEO (Ferguson) and CFO (Brandon)
6. Operational team flaws

The final factor in Bruner’s framework pertains to operational team flaws of which culture is arguably the most significant. Berkshire Hathaway’s superb results over time accurately reflect its performance-driven culture. The results Gen Re produced after its acquisition (see Exhibit 1) do not reflect a performance-driven culture,[18] and are symptomatic of operational team problems.

One way to assess operational team-related risk is by comparing a target’s operational structure with the acquirer’s. An approach for accomplishing this is presented in Exhibit 3.

This approach to operational team assessment starts with a vigorous analysis that is summarized in a narrative that thoughtfully considers each element. As a final step, each cell in Exhibit 3 could contain either a numerical rating (1 for low risk to 5 for unacceptably high risk) or a short summary of the risk assessment findings (high risk, moderate risk or low risk). Either approach can work so long as the risk assessment process is a vigorous one that produces a narrative that thoughtfully considers each element.

For example, consider the application of this approach to the “Executive Management” dimension of a target. Such an assessment could involve the following:

- **People**: formally profiling each of the target’s key executives to assess personality fit.
- **Process**: evaluating the processes under which the executives implement their strategy.
- **Technology**: assessing the technology utilized to generate executive information (and determining if that technology is compatible with the acquirer’s).
- **Measures**: determining if executive-level performance and risk measures are appropriate, and if they reconcile with the acquirer’s.

Such analysis provides a reasonable diagnostic with which to assess operational team-related risk, as long as it includes both a well-researched narrative and a numerical score or a word summary to highlight areas in need of targeted senior managerial attention during the integration process.

Avoiding future M&A disasters

Applying this overview of Bruner’s M&A risk assessment framework to a retrospective case study provides a clear understanding of how a skilled acquirer like Warren Buffet could make some uncharacteristic misjudgments. By using the framework prospectively, as a risk assessment tool, corporate leaders could treat each of its factors as a key question to be addressed prior to going to contract. Consider the example presented in Exhibit 4.

This exhibit is one way of practically applying Bruner’s framework to assess M&A risk. Admittedly, it is relatively high level. I encourage readers interested in further information to read *Deals From Hell – M&A Lessons That Rise Above the Ashes* (NY: Wiley, 2005). It contains a wealth of information that practitioners can use to avoid future M&A disasters, to which no one, not even Warren Buffett, is immune.

### Exhibit 3: Operational team assessment

<table>
<thead>
<tr>
<th>Dimension</th>
<th>People</th>
<th>Process</th>
<th>Technology</th>
<th>Measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Executive management</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Customer services</td>
<td></td>
<td></td>
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<tr>
<td>Internal operations</td>
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<tr>
<td>Knowledge management</td>
<td></td>
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</tbody>
</table>
Exhibit 4  M&A risk assessment

<table>
<thead>
<tr>
<th>Factor</th>
<th>Risk inquiry</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Complexity</td>
<td>- Is either the target’s business or the deal itself complicated (broadly defined)?</td>
</tr>
<tr>
<td></td>
<td>- If so, what steps are being taken to mitigate the complexity?</td>
</tr>
<tr>
<td>2. Tight coupling</td>
<td>- Is a premium being paid for the target?</td>
</tr>
<tr>
<td></td>
<td>- If so, have the assumptions supporting that premium been validated to the extent possible?</td>
</tr>
<tr>
<td>3. Business not as usual</td>
<td>- Is the business environment experiencing unusual events?</td>
</tr>
<tr>
<td></td>
<td>- If so, what mechanism is being utilized to control (or leverage) the effects of those events?</td>
</tr>
<tr>
<td>4. Cognitive biases</td>
<td>- Are deal-specific risk management devices (such as earn-outs, collars, etc.) being utilized?</td>
</tr>
<tr>
<td></td>
<td>- Have contingency plans been established to deal with unexpected developments that may arise post-acquisition?</td>
</tr>
<tr>
<td>5. Adverse management choices</td>
<td>- What are the processes to timely identify and address deal and post-deal issues that may arise?</td>
</tr>
<tr>
<td>6. Operational team flaws</td>
<td>- How is operational team-related risk assessed and managed?</td>
</tr>
</tbody>
</table>

Graham and Dodd methodology

Some investors, like Warren Buffet, credit much of their success as acquirers to the identification and exploitation of overlooked value. The methodology they use is a modern version of Graham and Dodd theory that assesses value along a unique continuum, which facilitates focused valuations of assets, earnings, competitive advantage, and growth in the context of one overall framework.[21] The comprehensive nature of that framework can reveal embedded elements of value, which at times can be underestimated or overlooked by practitioners of traditional forms of valuation. While the Graham and Dodd approach has been utilized successfully for many years by members of the investment community, it has thus far not been utilized to any great extent by M&A specialists. Hopefully, this will begin to change because the Graham and Dodd approach has a great deal to offer M&A specialists, from both a strategic and risk management perspective.

Notes

2. Ibid, pp. 67-75.
5. Ibid, p. 90.


15. For more information see, for example, “Recorded conversations erased reasonable doubt for jury in Finite Re Trial,” BestWire Services, March 3, 2008.


18. For more information see, for example, IBNR Weekly #31, Dowling & Partners, August 12, 2001.

19. This framework is based on the popular Balanced Scorecard concept. For more information see Robert Kaplan and David Norton, The Execution Premium (Boston, MA: HBS Press, 2008) and Robert Kaplan and David Norton, Alignment (Boston, MA: HBS Press, 2006).


21. For further information see Bruce Greenwald, Judd Kahn, Paul Sonkin, and Michael van Blerkom, Value Investing – From Graham to Buffett and Beyond (NY: Wiley, 2001).

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