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Getting to "Yes": Transactional Insurance Beyond Reps & Warranties

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TRADITIONAL INSURANCE BEYOND REPS & WARRANTIES

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Jeff Anderson, Senior VP M&A Division, Allied World

Introduction

M&A activity is increasing, but that does not mean that deals are getting easier to close. Representations & Warranties is an insurance product that has long been used to facilitate Mergers and Acquisition (M&A) transactions, but it is not the only insurance solution. This briefing looks at trends in M&A and other commercial transactions, the issues that often impede deals, and the insurance solutions to help simplify complex transactions.

Overview

The economic environment has been ripe for M&A activity in the U.S. in recent years. According to experts, both corporate and private equity deal volumes are predicted to accelerate for the foreseeable future. In fact, M&A activity in the U.S. has reached levels not seen since just prior to the economic crisis. According to KPMG, "Deal value for the first three quarters of 2014 reached almost $1 trillion. The 5,843 deals announced during the period are among the highest on record and represent a seven percent increase in volume and a 33 percent increase in value from 2013."

Economic conditions in the U.S. continue to improve, interest rates for the time being remain low, unemployment levels continue to decline, and equity markets remain strong. These factors contribute to a surplus of cash rich corporations and private equity money which is fueling expectations for increased M&A volume and values.

Closing deals can still be a challenge even with these favorable conditions, thanks to an increased emphasis on due diligence in the wake of the economic crisis. Jeff Anderson, Senior VP, North American M&A Group Leader, Allied World Insurance Company agrees. "Since the financial crisis, deal parties are more in-tune with risk generally, meaning they pay great attention to indemnity flowing from the seller to the buyer."

The M&A market has become more sophisticated and buyers are increasingly cautious as they strive to obtain a sufficient rate of return. In addition to adequate due diligence, factors such as proper target identification and valuation, and effective integration have become vitally important in determining the success of M&A transactions.

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These conditions have contributed to an increased reliance on transactional insurance to facilitate M&A negotiations, many of which would not close without such solutions. Transactional insurance is a collection of products offered by insurers that complement the M&A process by bridging gaps between buyers and sellers that would have otherwise prevented a deal from occurring. While none of the products are new, their use was limited in the past. Today, however, they are widely accepted and are increasingly relied upon to facilitate M&A transactions. The products include representations & warranties insurance, tax liability insurance, and contingent liability insurance.

Pain Points in the M&A Process

Issues that often arise in mergers and acquisitions could result in liabilities for the acquirer, which could stand in the way of a transaction closing if not resolved, include inaccurate representations, a breach of a warranty, unanticipated tax obligations, or potential liabilities of the selling company that are pending at the time the transaction is to close.

Inaccurate Representation and Breach of Warranty

Representations and warranties can be made by the seller and/or the buyer in an M&A transaction and provide an opportunity to disclose any potential issues and provide assurances prior to completing the transaction. Representations are statements of fact given by one party to encourage another party to engage in a transaction. Warranties are promises of indemnity if statements are proven to be false.

M&A agreements usually include an indemnification clause to protect against financial loss in the event that a representation made by one of the parties turns out to be inaccurate. Inaccurate representations can result in significant pain as they frequently result in costly litigation to enforce the indemnification clause.

A 2010 case pulled from Advisen's Master Significant Case and Actions Database (MSCAd) provides an example. In this case, financial services firm ING sold its subsidiary ING Fianzas SA to AXA. AXA claimed that ING falsely represented that its former subsidiary had sufficient collateral and/or reserves, as required under Mexican law, for the bonds it had issued. By the time AXA sold Fianzas to another bond company, it had paid millions of dollars on the bonds that it could not recover because Fianzas lacked the collateral or reserves that ING valued up to $162 million, according to the complaint filed in New York State Supreme Court. As a result of ING's alleged breaches of its representations and warranties, AXA claimed to have suffered $20 million in out-of-pocket damages.

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Obligations to taxing authority

Another significant pain point in the M&A process is related to post-merger challenges by a taxing authority to historical tax positions taken by the seller, or taxes that may arise where the structure of the agreement or the target company accounting practices is challenged by a taxing authority. Federal tax liability for unpaid taxes can result in the IRS placing a lien on assets owned at the time of sale. State and local tax liability varies by jurisdiction and can be placed on either the predecessoror the new owner.

If during the M&A due diligence process a potential tax exposure is identified in the target business, regardless of how remote the potential long-term liability, the possibility for challenges by a taxing authority could prevent the deal from going through if the seller is not prepared to indemnify the buyer post-closing.

Contingent Risks

A third pain point in the M&A process is exposures that are identified during the due diligence process that could lead to a financial loss for the buyer after the closing of the transaction. This differs from a loss due to inaccurate representations because the losses are caused by known exposures that have a clear potential to result in a loss. For example, if the seller is currently involved in pending or threatened litigation, the buyer may not want to proceed with the negotiation or the negotiations may become protracted while the parties attempt to quantify the contingent risk.

Insurance Solutions

The due diligence process will inevitably identify various risks that can lead to the application of various risk management strategies such as reducing the purchase price of the transaction, negotiating stronger contract terms (e.g., representations, indemnification caps, special indemnities, etc.), establishing escrow accounts, and obtaining parent company or other third-party guarantees.

In some cases, however, in order to facilitate a clean exit for the seller and a transaction with acceptable post-closing liabilities for the buyer, insurance is required. Insurers offer a collection of transactional insurance products that help bridge gaps in the M&A process between buyers and sellers that may have otherwise prevented a deal from occurring.

Representations and Warranties Insurance

Representation and warranties insurance provides indemnification for financial losses, including defense cost, arising out of a breach of seller's representations and warranties contained within a purchase agreement. This risk transfer tool is increasingly

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utilized to help bridge negotiating gaps over how much compensation (or indemnity) the seller is willing to offer the buyer and the level of compensation (or indemnity) the buyer will accept. Policies are negotiated on a deal-by-deal basis. Exclusions typically include criminal fines and penalties, post-closing purchase price adjustments, changes to the agreement without insurer consent, forward-looking warranties, and beforehand knowledge of breaches or fraud.

Policies can be purchased by either the buyer or the seller. A "buyer side" policy provides first-party liability coverage protecting the buyer from financial loss if the seller breaches a representation or warranty made at the time of signing or closing. Buyer side policies not only bridge negotiation gaps where the seller is unable to provide sufficient assurances but also protect commercial relationships and provide a strategic advantage in the bid process by allowing the buyer to accept lower liability thresholds from the seller.

"Since there is so much capital (private equity and otherwise) chasing deals these days, buyers need to differentiate their bids against other potential buyers" Anderson explains. "So procuring the insurance for themselves while minimizing the required representations and warranty indemnity from the sellers is a good way to distinguish their bid in a competitive auction situation."

"A newer trend has also developed in recent years. Sellers have a distinct interest in exiting positions or selling companies and leaving little tail or legacy liabilities" says Anderson. "So rather than fund an escrow, sellers would rather pre-package a buyer side representations and warranty insurance solution for the buyer when they sell the company. That way the seller gets certainty in both the sale proceeds and timing of liabilities."

A "seller side" policy provides third-party liability coverage that protects the seller by allowing the buyer or other third party to submit a claim against the seller to the insurance policy for a breached seller representation or warranty made at the time of signing or closing. Seller side policies are particularly valuable in order to provide certainty of purchase price funds for a selling shareholder or to backstop an escrow/ indemnity obligation of the seller.

Anderson tells us "Sellers benefit from transactional insurance so they can minimize legacy or tail liabilities. The insurance can be used to allow a clean and crisp exit from a position for a private equity group (or other sponsor) and also allows a company to sell itself without having to worry in later years about trailing liabilities.

Perhaps the seller is also the company founder and does not want to jeopardize her life's work in case something unanticipated arises post-close. This is a perfect situation for the seller to buy a Seller side representations and warranty policy."

Tax Liability Insurance

If a tax issue is identified during the M&A due diligence process a situation may arise whereby the seller and the buyer cannot agree on indemnification. Tax liability insurance, which is also referred to as tax opinion insurance, is a risk transfer product designed to address this situation. It covers issues related to historical tax positions of the target company that are either retained by the seller or assumed by buyer, and/or protects against tax risks that emerge at the time of the merger or acquisition. Policies typically cover the taxes, fines and penalties, interest, legal costs, and a gross up on insurance payments.

For example, explains Anderson, "If there has been restructuring for the target company that generates great tax benefits, the buyer does not want to have that legacy tax position challenged by the IRS post-close and lose the resulting tax treatment, perhaps retroactive to several years before the transaction. So, buying a tax opinion insurance policy allows all parties to move the risk (or disagreement) away from the deal so the parties can work on the other issues and move to close the deal."

Contingent Risk Insurance

If during the course of negotiations an issue is identified that could result in a financial loss after the transaction has closed, the buyer or the seller in the transaction can purchase contingent risk insurance to protect against the known liability. Coverage is usually provided for liabilities with a low probability but high potential severity. Contingent liability policies are specifically tailored to a particular exposure and give peace of mind to the parties involved in the transaction allowing them to focus on closing the deal. Exposures often addressed by contingent risk insurance include litigation risks, environmental risks, third-party intellectual property infringement claims, employment disputes or employee legal issues, and specific accounting treatment.

Conclusion

Transactional insurance products have been available for quite some time, but their use has increased in recent years as the value they bring to M&A deals has become more widely recognized. Given the uptick in M & A activity, it is likely that they will become increasingly commonplace in facilitating M&A transactions in the future.

1 Sherrie Nachman, KPMG, "2015 M&A Outlook Survey Report," http://www.execed.kpmg.com/content/PDF/kpmg-ma-outlook-2015-web.pdf