Client Savers & Deal Enablers

The use of insurance in M&A transactions is gaining popularity among deal professionals who are finding this tool increasingly useful to bridge the gap on one of the most fundamental deal issues in any M&A transaction: the potential post-closing erosion of value (either of the consideration received by the seller or the business acquired by the buyer). This brief discusses a few of the popular types of transaction insurance available to private equity and strategic buyers and sellers to help get deals done with a focus on effective and efficient use of risk allocated capital.

Overview

The issue of post-closing erosion of value (i.e., reconciling the seller's desire to protect its sale price and exit cleanly from its investment vs. the buyer's desire to be made whole if the asset it purchases is not what was bargained for), and how buyers and sellers choose to deal with it, manifests itself in various ways throughout the M&A process. As principals and deal professionals know all too well, post-closing contingencies and credit support mechanisms with respect thereto are significant factors that can impact overall purchase price, distinguish a particular bidder in a hotly contested auction, and can even be among the final negotiated business points that can make or break a deal. Today, the insurance industry provides a variety of risk transfer options designed and customized to assist deal professionals and principals in solving for these issues in a transaction. The costs of obtaining these insurance policies depend on various factors, including the scope of items covered, the survival period, and the amount of the deductible and cap (limit). Generally, however, the typical premium for obtaining a representation and warranty insurance policy is between 2–3.5% of the liability cap under the policy. The costs for other types of deal related insurance policies vary on a case-by-case basis. Note that the size of the deductible is often the most important element in the cost of an R&W insurance policy and allows the purchaser to balance their risk taking appetite.

Some of the main types of transactional insurance policies available are the following, each of which is discussed in greater detail below:

- Representations and Warranties ("R&W") Insurance
- Tax Indemnity Insurance
- Contingent Liability Insurance

R&W Insurance

The most common type of transaction insurance is R&W insurance, which can be obtained by either the buyer or seller (target). For a seller, a seller-side policy is typically used to backstop the seller's indemnification liabilities. By shifting the potential liability to the insurer at a fixed cost to the seller, the seller can ring-fence its exposure to ensure that the price it receives for its asset will not be eroded by post-closing claims for indemnification. In addition, a seller can often use insurance to better market its asset in a sale by either (i) providing greater indemnification coverage to the buyer than the seller would otherwise be willing or able to give (and backstopping the seller's indemnification exposure with a seller-side policy) or (ii) procuring a buyer-side policy (at seller's cost) directly for the buyer's benefit that provides for such added indemnification coverage.

Under a buyer-side policy, the insurance company pays the buyer directly for losses arising out of a breach of a representation or warranty. The policy can be used by the buyer as its sole source of recourse or can be used to supplement the seller's indemnification by providing coverage beyond the survival period and/or cap under the purchase agreement. In addition, a buyer can use an R&W insurance policy to distinguish its bid in a competitive sale process by reducing or even eliminating completely the need for a seller indemnity.

R&W insurance can also afford a buyer coverage in circumstances where indemnification traditionally has either been unavailable or impractical: for example, a buyer of assets out of bankruptcy; a buyer purchasing an asset from a private equity seller that is looking to wind down its fund or that is restricted under its fund documents from having ongoing indemnification liabilities; a buyer of assets from a distressed seller or from a seller group comprised of a large number of stakeholders; or a buyer of a public company in a going-private transaction.

Set forth below are some of the issues a deal professional who is interested in utilizing R&W insurance should consider when going through the process of obtaining and negotiating the terms of an R&W insurance policy.

Non-covered Items - Buyers and sellers should be aware that, for all of their benefits, R&W insurance policies do have certain limitations. For example, in addition to claims for injunctive, equitable or non-monetary relief, an R&W insurance policy will typically *not* cover claims with respect to:

- Purchase price adjustments
- Losses arising out of breaches of covenants
- Losses arising out of known issues, or issues stated on disclosure schedules
- Losses that fall within a deductible threshold (insurance deductibles are typically 1–2% of the transaction value)

Description of Indemnifiable Losses - The insured should make sure that the indemnifiable losses under the insurance policy match the scope of the expected indemnification. This is particularly true if the seller is the insured, since any discrepancy between the seller's indemnification liability and the insurance coverage will result in dollar-for-dollar exposure to the seller. Particular drafting points to consider in this context are whether the insurance policy and/ or seller's indemnification obligations cover losses arising out of a diminution in value or based on pricing or earnings multiples, or consequential, special, indirect, etc. damages; scrape materiality on a consistent basis; and take into account the same types of indemnification adjustments for taxes, insurance proceeds, etc.

Timing - Obtaining insurance for a transaction is a process that takes time, so parties need to plan ahead. Parties interested in using insurance policies for their deals should get the broker and the insurer involved as soon as possible in the process. Typically, after engaging a broker and entering into non-disclosure agreements, the broker, on behalf of the applicable insured, will submit certain materials (such as the business description of the target (information memo, if available), the most recent draft of the purchase agreement and schedules and the most recent financial statements of the target) to different insurers to obtain their pricing and coverage quotes, which usually are received within 3–4 days. Once an insurer is selected, the insurer will begin its 7–10 business day underwriting process, during which time the selected insurer will conduct its due diligence (which will typically cost approximately $10,000–$25,000, paid upfront). The due diligence investigation will entail the insurer obtaining access to the data room, reviewing transaction materials and conducting diligence calls. During this process, the policy terms will be negotiated with the applicant and its counsel.

Tax Indemnity Insurance

Another type of insurance product that is available is tax indemnity insurance, which is often designed to protect against losses arising from a historical tax position taken by the target. Even if the likelihood of liabilities arising from a particular tax position is remote, parties frequently have difficulty allocating between themselves exposure to such risk because such liabilities could have significant adverse consequences to the business. A tax indemnity policy helps bridge this gap by shifting the risk of loss to the insurer.

Tax indemnity insurance is sometimes also used to protect against losses if a transaction fails to qualify for an intended tax treatment. These policies can minimize or even eliminate liabilities that may arise from a successful challenge to the intended tax treatment of a transaction. In many deals, the tax treatment of the transaction is critical to structuring the deal and deciding whether to go forward, and in the event that a tax opinion or tax ruling is unavailable, a tax indemnity policy may give the deal participants the necessary comfort to proceed.

Contingent Liability Insurance

As previously noted R&W insurance typically does not cover known exposures or identified contingent liabilities. Identified risks, however, are often the subjects of a specific indemnity under purchase agreements, and in many cases present some of the most difficult issues for buyers and sellers to resolve. In response to these issues, some insurers now provide contingent liability insurance that may cover some or all of the exposure to those types of liabilities, subject to agreed-upon deductibles and limitations under the policy. The costs of these policies vary on a case-by-case basis due to the highly fact-specific nature of the risks being insured. Generally, the policies will be available if the risk is quantifiable, and the probability of the risk can be analyzed.

Related Risk Transfer Products for M&A Transactions

- Pollution Liability Insurance
- Tax Grant Indemnity Insurance
- Political Risk Insurance
- Trade Credit Insurance

- Prospectus Liability Insurance
- Claim or Litigation Buyout Insurance

Conclusion

Private equity and strategic buyers and sellers should be aware of all of the tools available to them in the current highly competitive deal market. Transaction insurance is one such tool that, if carefully crafted and strategically used, will provide the competitive edge that deal professionals are looking for to get deals done while effectively managing the risks. Deal professionals should discuss the possibility of using insurance in their deals with their legal and financial advisors, and insurance brokers, early on in the process to determine whether insurance is right for them in the context of their deal.

About the Author

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David L. Schaefer joined Armfield, Harrison & Thomas (AHT) in 1987. Mr. Schaefer graduated from Wittenberg University in 1984 with a B.A. Degree majoring in both Business Administration and Political Science/Pre-Law. His previous experience before joining Armfield, Harrison & Thomas includes working for McDonnell Douglas Corporation in their Information Systems Group and on Capitol Hill as a Legislative Assistant for a Member of The United States House of Representatives in the 98th and 99th Congresses.

Mr. Schaefer is a graduate of the USF&G School of Insurance and has obtained the designation of Chartered Property and Casualty Underwriter (CPCU) from the Insurance Institute of America. He is one of the first recipients of the Professional Liability Underwriting's Society's (PLUS) Registered Professional Liability Underwriter (RPLU) designation.

Mr. Schaefer has testified before committees of both the United States Senate and US House of Representatives and has advised the Office of Management and Budget regarding corporate risk management and insurance issues.

Mr. Schaefer has participated in panels across the country and written many briefs on the evolving and unique exposures that exist for technology applications, government contractors, management liability and international exposures and how to best manage the risks. He founded AHT's oldest and largest specialty the technology risk solutions practice group in 1992. Over the years he has been instrumental in assisting many organizations with the design, treatment and placement of their corporate risk management & insurance programs. He represents a variety of firms around the country and the world in this capacity.

Mr. Schaefer is a member of AHT's senior management and board of directors.

About AHT Insurance

AHT is a risk and benefit consulting and brokerage organization dedicated to addressing the risk management and insurance needs and exposures for business. A 93 year-old, employee-owned, independent insurance brokerage and risk management consulting firm, AHT is headquartered in the Washington, DC metropolitan area, with offices on both coasts of the United States. AHT has an extensive international practice, representing clients with thousands of workers overseas and a physical presence in over 80 countries. AHT is one of the largest private independent insurance brokerage firms in the United States. AHT is currently ranked as a "Top 100 Insurance Broker of US Based Business" by Business Insurance magazine.

Specializing in Technology, Government Contractors, Private Equity, Non-governmental Organizations, Manufacturing, Non-profits, Professional Liability, Corporate Management and Multinational exposures, AHT has extensive expertise advising on products liability, international exposures, mergers & acquisitions, professional liability risk and other related insurance coverages. AHT offers clients unique risk management services, a deep bench of experienced professionals and secure web-based service capabilities that improve the effectiveness and efficiency of risk management and related insurance programs.

AHT currently has a staff of 160 people working from 3 primary offices located in the Washington, New York and Seattle metropolitan areas. The firm maintains field offices in Connecticut, Kansas, Maryland, Virginia and Wisconsin. AHT is a partner and resource for several global networks to provide a superior service model for our clientele while maintaining extreme efficiency managing the overhead costs associated with global insurance and risk management networks. AHT is a founding member of TechAssure, the only technology-focused insurance and risk management consulting association in the world. The firm is also a member of RiskProNet and Unison global broker networks and maintains an active presence at Lloyd's of London.

AHT has been recognized in the industry as a persistent outstanding performer. In addition to annually receiving recognition from many of the largest commercial insurers in the world for a growing portfolio of clients that consistently outperforms market averages by a wide margin, AHT has received the following awards:

- *"Agency of the Year" – Rough Notes magazine*
- *"Best Practices Firm" – Independent Insurance Agents and Brokers Association of America (IIABA)*
- *"Top 100 US Insurance Broker" – Business Insurance magazine*
- *"Best Places to Work in Insurance" - Business Insurance magazine 2009, 2010, 2011, 2012, 2013*
- *"Champion – Technology Achievement Award" – National Underwriter magazine*