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Facilitating M&A Transactions

Terms, Conditions, Benefits and Pitfalls of Transaction-Related Insurance Products

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Presenters

- **Jonathan Legge** manages the Transactional Risk and Executive Liability Practices at Vanbridge. He was one of the original brokers involved with transaction-related insurance products. He was the founder and global head of transaction-related insurance at Marsh & McLennan, the largest insurance broker in the world. Jonathan has structured, negotiated and brokered over 100 transaction-related insurance products.
- **John McNally** joined Beazley in January 2010 and leads the Transaction Liability Team. John has been underwriting representations and warranties, tax and contingent liability risks, both internationally and in the U.S., since 1999. John's previous experience was in complex claim litigation, including D&O, environmental and product liability.
- **Bill Kucera** is Co-Chair of Mayer Brown's M&A practice in the Americas. He has extensive experience with M&A Insurance, both in representing insurers in underwriting insurance in M&A deals as well as representing principals to M&A transactions procuring insurance.

Overview

- In recent years, insurance has emerged as an important tool in managing and mitigating a wide variety of transaction-related risks, from representations and warranties, to tax risk, to environmental and other contingent liabilities.
 - In 2013, over \$2 billion of risk was assumed by insurers
- Tool that deal professionals should understand

Traditional M&A Risk Management

- Number of traditional methods for managing risk in M&A transactions including:
 - Reduced purchase price (self insure)
 - Negotiate stronger contractual protections – strong reps, higher caps, special indemnities, etc.
 - Escrow or holdback
 - Offset against earnout or other deferred consideration
 - Parent or other third-party guarantees

Challenges of Traditional M&A Risk Management

- Challenges of traditional M&A risk management include:
 - Difficulty in negotiating – indemnification / risk shifting often among the hardest issues on which to reach agreement
 - The Buyer is exposed to the credit and collection risk
 - If there is a disagreement regarding payment, the Buyer may have to litigate with the Seller to recover (current management may be a part of the selling group), with both sides wasting resources in a dispute.

Uses of M&A Insurance

Situations to consider using M&A Insurance:

- Bridge negotiating gaps – either risk management generally or certain specifically indentified liabilities or potential liabilities
- Sellers: Want to sell but limited leverage; must agree to onerous indemnification terms to get deal done
- Buyers: Circumstances in which sellers offer limited or no viable means of most closing recourse
 - E.g. widely dispersed ownership among numerous shareholders
- Auctions
 - Sellers: Include “stapled” policy as part of process to take indemnification issue off the table
 - Buyers: Use insurance as means to differentiate from competition – agree to seller’s proposed indemnification structure (or something similar) and plug gaps with insurance

Insurance Product Overview

- Insurance has emerged as an important risk management tool in addressing M&A related risks
- Transactional Risk insurance products have been available in the United States since the mid-1990's
- In the last two years, the take up rate of these products has increased dramatically. The growth has been driven by:
 - The number of insurers providing the product has increased, as has capacity and risk appetite
 - Underwriting is more streamlined and faster
 - Cost of coverage has decreased
 - Low interest rates make it difficult to earn a meaningful return on escrowed funds
 - The traditional mechanisms for addressing unknown or contingent liabilities can be inefficient when compared to insurance

Impact of Risk Shifting Mechanism					
		Good Protection		Good Return	
		Buyer		Seller	
Escrow		Yes		No	
Holdback		Yes		No	
Uncollateralized Indemnification		No		No	
Insurance		Yes		Yes	

Insurance provides protection for both parties and a good return for the Seller

Typical R&W Insurance Terms & Conditions

A typical Representation and Warranty Insurance Policy has the following basic terms and conditions:

• Coverage:	<ul style="list-style-type: none">• Provides the Buyer with insurance against a breach of the Seller• Representations and Warranties as stated in the Purchase and Sale Agreement• Coverage includes both indemnity for loss and legal and defense costs
• Retention (deductible):	<ul style="list-style-type: none">• Typically 1% to 2% of the purchase price.
• Limits Available:	<ul style="list-style-type: none">• Up to \$400 million available for any given transaction, but the typical coverage is 10% - 20% of deal price
• Due Diligence Fee:	<ul style="list-style-type: none">• \$15,000 to \$30,000 in addition to the premium
• Premium Range:	<ul style="list-style-type: none">• 2% - 5% of purchased limit
• Policy Period:	<ul style="list-style-type: none">• Follows the Purchase & Sale Agreement up to a maximum of six years
• Effective Date:	<ul style="list-style-type: none">• Typically put in place at closing. Can be bound at the time of signing with a deposit premium paid
• Key Definitions:	
• Breach:	<ul style="list-style-type: none">• Needs to reference the specific sections of the PSA
• Defense Costs:	<ul style="list-style-type: none">• Fees costs and expenses incurred in the investigation, defense or settlement of a Third Party Demand
• Specified Person:	<ul style="list-style-type: none">• Deal team members and senior management who are required to represent that they do not know of an inaccuracy in the representations & warranties at the time coverage is bound

Typical R&W Insurance Terms and Conditions

- **Typical Exclusions:**

- ✓ Purchase price adjustment provisions in the PSA
- ✓ Any post-Closing covenant
- ✓ Unfunded or underfunded benefit plans
- ✓ Taxes incurred as a consequence of the transaction
- ✓ Non-monetary relief, other than defense costs

- **General Terms:**

- ✓ Claims notice within 60 days of a Specified Person becomes aware of a breach
- ✓ Insurer must consent to a settlement of Third Party Demands
- ✓ The Insured must make commercially reasonable efforts to mitigate a potential claim
- ✓ The insurer is subrogated to any rights of the insured. This needs to be negotiated with the insurer
- ✓ To the extent that insurance pays and there is recourse to the Seller, the Insurer steps into the Buyer's shoes to pay those claims so that the Insurer is the first party to be reimbursed
- ✓ Arbitration is required for dispute resolution

Addressing the Gap Between Buyer and Seller Expectations

Buy-side policies

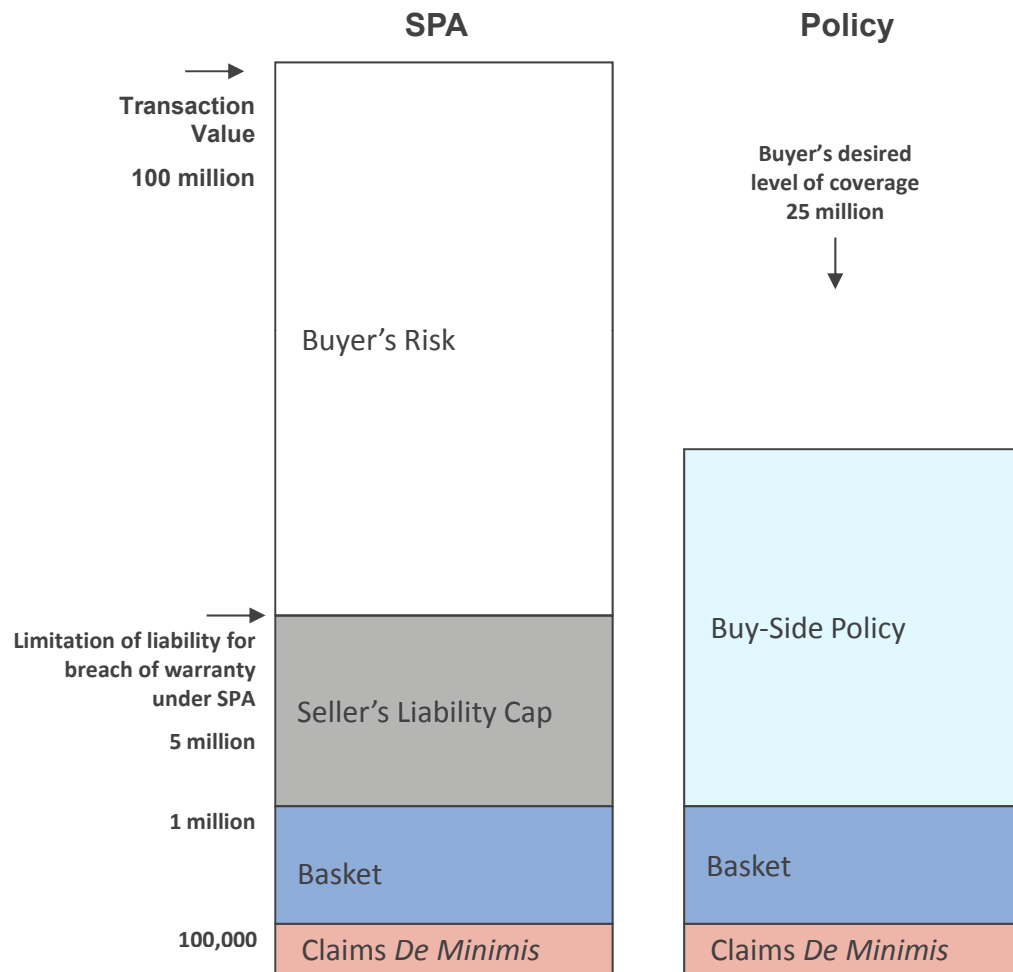
- Provide additional (or parallel) recourse alongside the liability of the seller/ warrantor under the SPA.
 - Can offer increased financial recourse, extend time periods, or both
 - Will import many of the SPA provisions, but will disregard the seller cap and (frequently) time limitations
 - Policy retention typically set at seller/ warrantor cap
 - Can be structured to achieve a seller “clean exit” i.e. no post-close R&W liability for seller – subject to adequate disclosure and the buyer retaining some first loss liability

Addressing the Gap Between Buyer and Seller Expectations (Cont'd)

Sell-side policies

- Respond directly to buyer's action for breach of R&W or tax covenant in purchase agreement.
 - Interests aligned with insured – i.e. to defend a claim vs. buyer
 - Benefit from assistance/ experience of insurer but give away full flexibility/discretion on claims defence
 - There has to be a liability which is being insured – i.e. the purchase agreement allows for the possibility of a claim otherwise policies may be voidable for lack of “insurable interest”
 - Policy will mirror time limits and de minimis values in the purchase agreement
 - Policy will have a retention (or policy excess) to incentivize seller and align interests

Sample R&W Policy Structure: Buy-Side “Top-Up” Policy

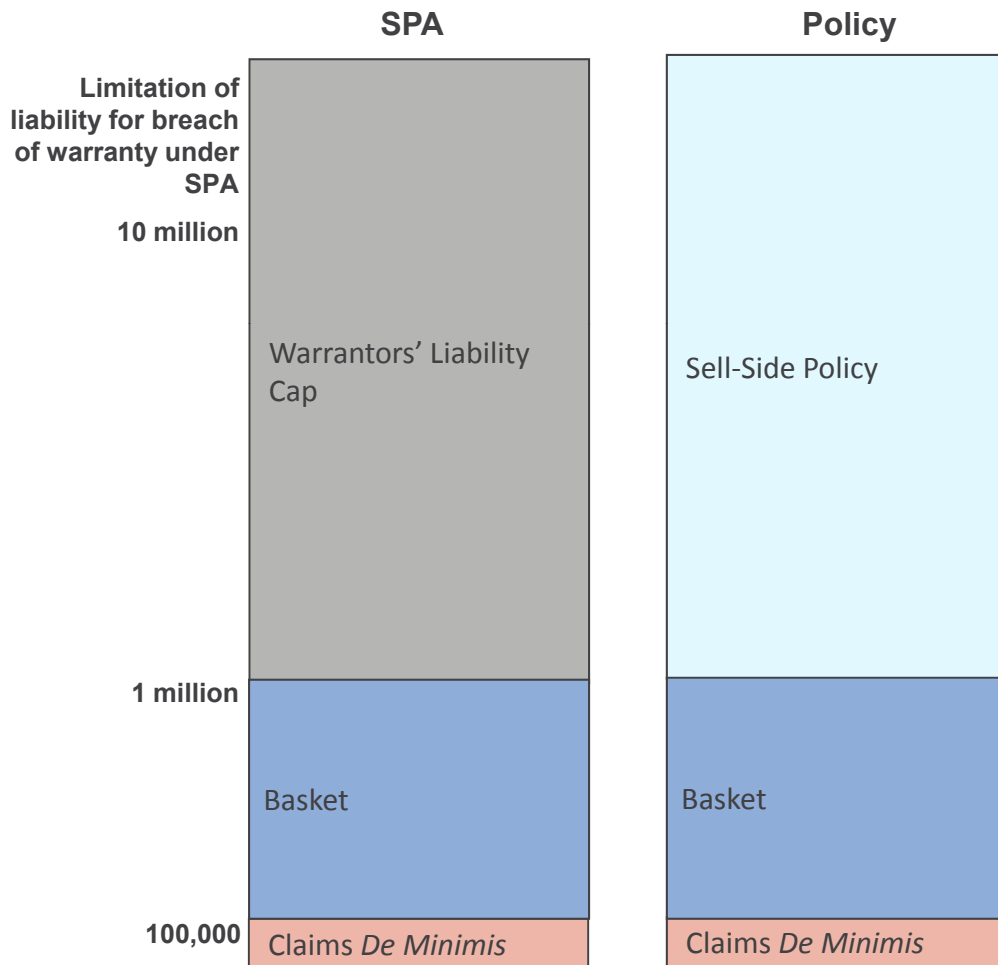


Insured: Buyer

Objective: To provide coverage against loss suffered as a result of a breach of seller's representations.

Structure: Seller gives representations but these with losses capped at a lower amount. The insurance policy sits in excess of the cap on losses in the purchase agreement.

Sample R&W Policy Structure: Seller Policy



Insured: Seller

Objective: To provide coverage against loss suffered as a result of a breach of seller's representations. Typically used when management makes the representations and is transferring with the sale. This policy allows the buyer to recover against the insurer instead of management.

Structure: Management gives warranties up to a capped amount. The insurance policy sits parallel to management's liability.

What are the financial considerations?

How does it work?

- How does it work?
 - Replace or reduce escrow to allow efficient redeployment (or distribution) of capital
- R&W insurance – average RoL is 3% of limit; average limit is 10% of deal value
 - How is cost measured as a % of deal value? So for a USD 100 million deal, premium would be USD 300,000 (USD 10m @ 3% RoL) or 0.3% of deal value
- What is the cost of leaving USD 10 million in escrow for 2 years?
 - Earn 2% pa or USD 400,000
 - Versus reinvesting at 20% pa (USD 4 million)
 - Net loss is USD 3.3 million even without claims
 - Or liquidating the fund 2 years earlier (instead of 20% pa returns over 6 years, becomes 15% pa over 8 years) – will affect next fundraising as well as average return

Practical Considerations

- Addressing Exclusion of Disclosed and Known Claims
 - It is important to review the data room thoroughly
 - Buyer should assume that all matters disclosed in the data room will be deemed disclosed and therefore excluded from coverage, especially in EU deals.
 - Exclude hypothetical risks from due diligence reports
 - Buyer should assume that all matters disclosed in due diligence reports will be deemed disclosed and therefore excluded from coverage.
 - Known risks must be addressed in the purchase agreement because they will not be covered under the insurance policy
 - Purchase price reduction, specific indemnity, escrow account.

Practical Considerations (Cont'd)

- Conduct Adequate Due Diligence
 - Insurers review the data room and due diligence reports to ensure that buyer conducted adequate due diligence.
- Engage in Robust Negotiations
 - Insurers seek confirmation that the parties engaged in meaningful, arms'-length negotiations rather than simply allocating risk to the insurer.

Other Types of Transactional Insurance

Tax insurance

- Written to respond directly to an identified tax issue
 - M&A Context. CGT issues, SDLT and other Real Estate tax, tax treaties, tax free spinoffs and S Corp.
 - Non-M&A Context. FIN 48 issues, tax credits, fiscal neutrality applicability (e.g. VAT), etc.

Contingent liability/ litigation insurance

- As per tax, written to respond directly to an identified issue
 - “Known” issues which are a deal obstacle, including contingent claims or active litigation

Fund Liquidation Insurance

- Written to permit the release of retained capital held against multiple contingent indemnification liabilities

THANK YOU

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