M&A in 2015: Reps and warranties insurance

Norton Rose Fulbright
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• Today’s program will be conducted in a listen-only mode. To ask an online question at any time throughout the program, click on the question mark icon located on the toolbar in the bottom right side of your screen. Time permitting, we will answer your question during the session.

• Everything we say today is opinion. We are not dispensing legal advice, and listening does not establish an attorney-client relationship. This discussion is off the record. You may not quote the speakers without our express written permission. If the press is listening, you may contact us, and we may be able to speak on the record.
M&A in 2015: Reps and warranties insurance

What is it, why do you want it, and how do you negotiate it?
Agenda

• Overview
• Representations & Warranties Insurance
  – Structuring and negotiating coverage and exclusions
  – Underwriting process
  – Trends
• Claims and claims process
• Tax Liability Insurance
• Contingent Liability Insurance
• Concluding Thoughts
Overview
Mergers & Acquisitions Basics

• Mergers & Acquisitions (M&A) - the buying, selling, dividing and combining of different companies or assets

• Size of the M&A Market - $3.5 Trillion of M&A deal value in 2014, 40,400 deals announced

• Different Types of Buyers - Strategic vs. Financial Sponsors

• Different Types of Targets - Public vs. Private Targets


• How Does it Usually Work? Asset Deal? Stock Transaction? Merger?

• Global Market with Increasing Cross-border Deals
Issues Inherent to Mergers & Acquisitions

• Buyers and sellers may have different ideas about how known and unknown risks on a transaction should be addressed;

• Buyers want security and protection, sellers want a clean exit from investments;

• Sellers may receive offers from multiple bidders, buyers want to distinguish their bids in a competitive sale process;

• Buyers may not be willing or able to seek recourse against a seller for losses related to a transaction; and

• Every jurisdiction presents unique challenges and risks to buyers and sellers.
Representations and Warranties Insurance

What is Representations & Warranties (R&W) Insurance?

- Insurance product that protects a party from financial losses resulting from inaccuracies in the representations and warranties made about the target company or business in connection with transactions, including mergers, acquisitions and divestitures
  - Takes the risk off both parties to the transaction
  - Covers fundamental and non-fundamental representations and warranties
  - Can potentially cover other specified indemnities
  - Facilitates mergers, acquisitions, divestitures and other business transactions
  - Provides access to the insurance industry’s capital and allow the transfer of certain transaction-related risks to the insurance markets
Representations and Warranties Insurance

Maturing Market; Rapid Growth Rate

- Introduced to U.S. Market in 1998
- Over 1500 R&W policies issued to date by AIG, insuring over $15 billion
- AIG closed over 415 R&W transactions during 2014

Current State of the Market

- Very seller-friendly M&A market
- Past economic downturns resulted in more risk averse buyers and sellers
- Broad coverage and favorable terms
- Rapid response time and efficient underwriting process
- Greater awareness, understanding, and recognition of product from the M&A community
- Proven claims paying ability
- Specific industries may garner different treatment
Representations and Warranties Insurance

Why Buyers request coverage:

• Buyer is unable to obtain desired level of seller indemnification
• Buyer is unable to obtain the duration of indemnification it wants
• Buyer wants to distinguish its bid over other bids in competitive auction
• Buyer is concerned about its ability to collect on the indemnity
• Buyer wants to protect its deal
• Buyer wants to protect key relationships
• Buyer wants to supplement its due diligence efforts

Why Sellers request coverage:

• Seller wants to reduce the risk of contingent liabilities
• Seller wants to distribute sale proceeds – clean exit
• Seller is motivated by strategic considerations
• Seller wants to supplement its due diligence and disclosure process
• Seller is motivated by financial considerations
• Seller needs to address stakeholder concerns
Representations and Warranties Insurance

Coverage Highlights:

• **Two Types of Policies:**
  – Buyer-Side Policy
  – Seller-Side Policy

• **Amount of Coverage:** Up to $50 million for any one transaction; Larger programs can be structured with additional insurers

• **Price of Coverage:** Generally 2% to 5% of the limit of liability

• **Retention/Deductible:** Generally 1% to 3% of the transaction value

• **Policy Period:**
  – Typically matches survival in underlying agreement
  – Can be extended beyond survival in underlying agreement

• **Coverage Candidates:** $50 million to $3 billion in purchase price

• **Underwriting Fee:** Between $25,000 - $50,000
Buy-Side Policy

**Insured:** The buyer

**Objective:** To provide coverage against financial loss suffered as a result of a breach of the seller’s warranties

**Structure:** Sellers give warranties but these are capped at a lower amount, the insurance policy sits in excess of this

**First party policy:** Policy is independent of the seller, therefore the buyer is entitled to make a claim directly against the policy.

**Insured:** The buyer

**Objective:** To provide coverage against financial loss suffered as a result of a breach of the seller’s warranties

**Structure:** Sellers give warranties but these are capped at a lower amount, the insurance policy sits in excess of this

**First party policy:** Policy is independent of the seller, therefore the buyer is entitled to make a claim directly against the policy.
Sell-Side Policy

**Insured:** The sellers

**Objective:** To provide coverage in the event that the buyer sues the seller for a breach of warranty or indemnity

**Structure:** Can insure up to the warranty cap as defined by the sale document

**Policy of indemnity:** Seller still retains liability under sale document, therefore is liable for any breach not picked up by the insurance policy
Streamlined Underwriting Process

Depending on stage of transaction, policy can be underwritten in as little as 5 days from start to finish.

1. Execute NDA
2. Provide Submission to Insurer
   - Requested information includes acquisition agreement, financial information, offering memo
3. Obtain quote within 2-5 days
   - No cost to obtain quote
4. Agree to Non-Binding Indication Letter (NBIL) and pay underwriting fee
   - Typically between $25,000 and $50,000 – satisfies AIG’s outside counsel fees
5. Underwriting process: 5-10 days
   - High level review of due diligence process (if buyer-side) or disclosure process (if seller-side)
   - Access to legal, financial, tax DD reports (if buyer-side)
   - Conference call(s) with deal team
6. Policy negotiations
   - Concurrent with underwriting process
   - Work closely with outside counsel
Underwriting Considerations

- Identity of the buyer, seller and their advisors.
- Sector of target business and location.
- Quality of the transaction process.
- Quality of due diligence/disclosures.
- Value of transaction.
- Scope of the insured warranties - buyer or seller friendly?
- Seller’s liability under the SPA.
- Gap between signing and completion?
- Why do they want insurance?
- Do both parties know about insurance?
Negotiating R&W Insurance – Considerations

• Coverage – Amount? Size of the transaction? Any escrow?
• Policy Period – Does it match the survival period of the reps and warranties?
• Premium – Cost and who pays for the R&W insurance?
• Deductible/Retention – Amount? Responsibility for losses up to retention?
  – Escrow could serve to fund deductible
• Policy language
• Definition of Loss
• Subrogation
• Materiality Scrape
Exclusions

• R&W Insurance does not typically cover the following:
  – Actual knowledge of a breach
  – Fraud
  – Consequential, multiplied, punitive or exemplary damages
  – Projections or forward looking statements
  – Adjustments to the purchase price related to working capital
  – Criminal fines and penalties (where uninsurable by law)
  – Unfunded or underfunded benefit plans
  – Asbestos

• Other potential exclusions that are transaction specific:
  – Environmental (depends on the transaction)
  – Medicare/Medicaid exclusions
  – Regulatory risks
  – Bribery/anti-corruption
Trends in R&W Insurance

• The market for R&W insurance has changed over the last 6-10 years:
  – Pricing for coverage
  – Deductible/Retention
  – Terms
  – Frequency of use
  – Aggregate size of coverage
  – Claims activity
  – Underwriting Process

• The amount of R&W insurance policies purchased have increased almost sevenfold since 2011.

• In 2011, AIG had 215 submissions for R&W insurance and in 2014, AIG had 1150 submissions.

• In 2011, AIG had 35 R&W insurance policies bound and in 2014, AIG had 230 policies bound.
Other Considerations – Moral Hazard

• When perceived risk is reduced, the risky behavior increases

• Examples:
  – Increased head injuries with football helmets
  – More leg injuries with quick release ski bindings
  – People tailgate more with anti-lock brakes
  – Arson increase with fire insurance
  – Motorists drive closer to helmeted cyclists

• Risk homeostasis

• May not be a “moral” issue
Other Considerations – Moral Hazard

• Implications for deal makers
  – Extra emphasis on quality control in due diligence
  – Timing of the insurance proposal
    o For buyers: auction process, term sheet/letter of intent phase, during difficult negotiations with seller
    o For sellers: pre-market with negotiated policy, during the transaction negotiations, after the closing
  – Nature of the risks sought to be insured: controllable or random?

• Insurers and counsel
  – Eyes open for red flags – diligence
  – Drift on representations and warranties language
Other Considerations – Adverse Selection

• Information asymmetry: someone has a secret

• Examples:
  – Patient knows he has pains in his chest, and applies for insurance (“pre-existing condition”)
  – Lots of obese people at all-you-can-eat buffets

• Results
  – Pricing mistakes
  – Death spiral?

• Implications for deal makers
  – Red flags – is the “risk” floating to a “certainty”
  – Is the risk generally viewed the same in other deals?
Other Considerations – Points to Ponder

• Value added by professionals
  – Negotiators’ battle lines: Indemnity caps, baskets, deductibles, exclusions, time limits
  – Insurance market says: All these, together, are worth 3%

• Run to the other side of the deck?
  – Who pays the premium?
  – Who pays the deductible?
  – Negotiation of policy terms and conditions?

• Can you anticipate issues to use R&W insurance to your client’s advantage?
Claims
Claims Scenarios

Patent Infringement

• Seller-side policy responds to claim brought by buyer for breach of the IP R&Ws resulting from a third party claim of patent infringement

Accounts Receivable

• Seller-side policy responds to a claim brought by buyer for breach of the financial statements R&Ws in connection with the target’s issuance of over $1mm of gift certificates which had not been recorded in the financial statements

Material Adverse Change

• Buyer-side policy responds to a claim brought by the buyer against the seller and the R&W insurance policy for alleged breaches of the R&W regarding operation of the business in the ordinary course and no MAE between the date of the interim financial statements and the closing, among others
Claims Process

• Timing of claims
• Size of claims
• Notice requirements
• Response considerations
• Diligence
• Claim resolution
• Examples
Frequency of Claims Made

In Americas (1998-2013):

Claim frequency of 28% of the policies issued (i.e. approximately 1 in 3.5 policies)

In EMEA and APAC (2002-2013):

Claim frequency of 12% of the policies issued (i.e. approximately 1 in 8 policies)
Types of Alleged Breaches – Global
Tax Liability Insurance
Tax Liability Insurance

Enables the insured to reduce or eliminate a contingent tax exposure arising from tax treatment of a transaction, investment or other tax position where the underlying legal conclusions may be subject to future challenge by the IRS or state or foreign tax authorities.

Provides Coverage for a Variety of Tax Exposures

- Federal, state, local or foreign taxes (policy period tracks applicable statutes of limitations)
- Expenses of legal/financial advisors incurred in resolving disputes with the IRS and/or other taxing authorities
- Gross-up of taxes payable with respect to insurance proceeds in the event of a loss and insurance recovery
- Interest and non-criminal fines or penalties related to determined tax liability
Tax Liability Insurance

Examples of Covered Exposures:

• Protection of tax-free status of corporate spin-offs, split-ups or split-offs
• Tax consequences resulting from a change in ownership
• Tax consequences resulting from the characterization of assets as real property
• Certain tax issues related to the determination of the allowable net operating losses in a “change of control” context
• Certain tax issues arising from golden parachute payments
Tax Liability Insurance

Tax liability insurance is NOT AVAILABLE for the following scenarios:

- Prepackaged off-the-shelf investment products
- Repetitive transactions for the same taxpayer
- Transactions with no independent economic business purpose (e.g., listed transactions, tax shelters)
- Transactions under audit or in litigation
- Requests to insure changes in current or future tax legislation

Amount and price of coverage vary with the type of exposure and insurance structure
Contingent Liability Insurance
Contingent Liability Insurance

Eliminates or reduces contingent liability exposure related to the business of the seller or otherwise arising out of an M&A transaction

Coverage Available for a Wide Variety of Exposures Arising in the M&A Context, including:

- Specific indemnity obligations
- Successor liability issues
- Contractual consent issues
- Governmental approval of a transaction
- Fraudulent conveyance
- Litigation
Contingent Liability Insurance

Flexible Structures to Accommodate Insured’s Specific Needs:

• Coverage can be excess of existing insurance or an indemnity
• Coverage can backstop an existing indemnity for the exposure
• Coverage can act as primary recourse

Amount and price of coverage vary with the type of exposure and insurance structure

Defense costs may be included in the program’s limit at the option of the insured
Concluding Thoughts
Case Study – Using R&W and Tax Insurance to Gain a Competitive Advantage

Situation

• A U.S. corporate buyer is considering bidding to acquire a manufacturing company with operations in South Africa in a competitive process.

• Seller is a private equity fund that has only a few portfolio companies remaining in the fund.

• Buyer has not purchased any businesses in South Africa before, and the acquisition would provide a useful entry point into a new market.

• Due diligence has identified a contingent tax risk that, in the unlikely event that the taxing authority were to take an adverse view, could result in a significant liability. It is anticipated that most bidders will require a specific indemnity from the seller for this issue.

Process Undertaken

• Buyer recognizes that, because the PE fund will be looking to wrap up the fund, indemnity terms will be important to this seller.

• In its bid, buyer proposes a relatively low indemnity cap in the form of an escrow (1% of the deal value) and structures a buyer-based R&W policy to sit above the escrow for an additional 25% of the purchase price.

• Buyer obtains a Tax Liability policy to cover potential tax, interest, penalties and defense costs from the identified tax issue.

Results

• Buyer prevails in the competitive sales process and acquires the target company, despite the fact the other bidder offered a higher purchase prices.

• Seller was particularly attracted to the “clean exit” provided by the small escrow and indemnity cap, and the lack of an indemnity obligation for the tax issue.
Case Study – Scope of Coverage

Will Representations and Warranties Insurance protect a buyer purchasing the business described below?

A family owned business in Texas has provided services to the energy sector for the past 15 years. The founding partner wants to retire and hopes to sell the company for around $100 million. Some of the family members that own the business want to continue to work for the business after the sale, but other family owners know little about the business and are excited about the potential liquidity event.

The target has some light manufacturing facilities with potential environmental exposure, the books and records of the company are not in perfect order, there is a contractual dispute between the target and another one of its key customers and there is a threat that new legislation may impact how the company operates.
Concluding Thoughts

M&A Insurance is a resource for dealmakers to facilitate transactions

Transactional Insurance Products may be helpful at any stage of the transaction

M&A Insurance teams can help you:

• Understand your transaction and your issue(s)
• Provide insurance solutions that offer satisfactory risk transfer at a reasonable cost
• Respond in an expeditious manner
• Add value to your transaction team, by offering ideas and solutions throughout the transaction process
For Further Information

Representations & Warranties Insurance

http://www.aig.com/_3171_417762.html
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