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M&A insurance enters the mainstream

by Mary Duffy

Although they have been used in deals for some time, M&A insurance products, also referred to as transaction liability products, are still considered a novelty by many people in the deal community. That's beginning to change.

Dealmakers are increasingly turning to M&A insurance as a solution to many of the challenges that get in the way of closing a deal. While still used in a small minority of US deals, the number of policies placed within the country has grown dramatically over the past two years. The insurance is more prevalent in markets like the UK, where it has been around for a longer period of time.

M&A insurance – the basics

The most frequently used M&A insurance product is representations & warranties insurance (RWI), which in some countries is referred to as warranty & indemnity insurance. RWI protects buyers and sellers from losses arising from inaccuracies in the representations and warranties made by the seller or target company in connection with an M&A deal. RWI enables them to protect against losses discovered post-closing. In the absence of RWI, the buyer typically tries to negotiate a substantial indemnity from the seller to protect against this scenario, often backed by an escrow, letter of credit or financial guarantee. Failure of the parties to agree on the scope of the seller indemnity is one of the most common reasons that deals go off the rails.

RWI policies can be crafted to address both buyer- and seller-specific concerns. A buyer-side policy covers the buyer for losses resulting from inaccuracies in the seller's or target's representations and warranties, and in many cases allows the buyer to recover losses directly from the insurer without the need to initially pursue recovery from the seller. A seller-side policy pays losses on behalf of the seller resulting from claims by the buyer, basically protecting the seller from having to return a portion of the purchase price. Frequently sellers look to use RWI as a tool to minimise or eliminate the need for an escrow.

Other M&A insurance tools include tax insurance and contingent liability policies. Tax insurance is used when there is uncertainty in the application of tax laws, or inadequate time for a taxpayer to obtain an advance tax ruling. This tool can be used to mitigate tax risk associated with the transaction structure. It can also address contingent tax liabilities identified by the buyer in the due diligence process.

Contingent liability coverage refers to an insurance policy crafted to cover a specific risk associated with an M&A transaction. These are bespoke policies that are tailored to a specific risk and a specific deal, which can be instrumental when the buyer and seller can't agree on how the risk should be allocated.

From 'novelty' to 'normal'

In the early years after RWI policies were introduced in the US, their use was fairly rare. A few private equity funds and corporate buyers were early adopters, as they recognised the potential strategic value of deploying the insurance to aid in closing deals and, in many cases, to negotiate more favourable terms. However, at the time most dealmakers were reluctant to try the RWI approach, viewing it as novel and untested and they used RWI on rare occasions.

Several factors have pulled RWI towards greater acceptance within the deal community. First, with the availability of the product for more than 15 years in the US, there is a greater familiarity with RWI. More

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and more deal-makers have used RWI at least once or have observed it used successfully on a deal. Many are now aware of claims that have been paid from RWI insurance, boosting recognition of the value RWI can provide to the M&A community. As legal counsel increasingly become familiar with the policies and how they work, they are more likely to recommend RWI as a tool. An important driver of RWI use in deals may be the drop in premium, as rates have come down significantly in recent years. Today, a typical solution will be priced at 2-4 percent of the insured limit of liability for deals in the US and can be 1-2 percent on some non-US deals. Some markets adopted RWI earlier than others, like the UK and Australia, but interest in emerging markets is growing fast in places like Asia and Latin America.

Successful deal strategies

While RWI is theoretically applicable to virtually every deal, there are a few scenarios in which the value to buyers and sellers is most compelling.

Managing post-closing exposure in exits. Virtually every seller would prefer an exit that is as clean and smooth as possible, but for some it is more imperative. For a private equity seller looking to close a fund, a post-closing indemnity (which frequently survives for seven years or longer) can be problematic. Similarly, the long tail of indemnity obligations can cause problems for individual selling shareholders, whether the deal involves a selling founder, family-owned business, or other individual shareholders. In these scenarios, sellers can negotiate to incorporate RWI into the deal, and accordingly achieve a higher degree of certainty at closing.

Bidding strategies in auctions. In an auction or other competitive situation, buyers can use RWI strategically to improve the attractiveness of their bid. Since managing post-closing liability is a priority for most sellers, a buyer can often win a deal by minimising the requested indemnity cap (or escrow) and instead rely on a RWI policy. In some cases, buyers have prevailed using this strategy even when their offer was not the highest bid.

Cross-border deals. When a buyer is considering an acquisition outside of its home country, there is often apprehension about the difficulty in collecting on the seller's indemnity. A lack of familiarity with local laws of the target company's country can exacerbate the challenge. In those cases, buyers can secure a bit of comfort if there is an RWI insurance policy placed in the buyer's home country to cover those losses. There are corporate buyers who rarely use RWI on domestic deals, but use it on almost all cross-border deals. This trend is gaining speed as many RWI insurers gain comfort insuring deals in emerging markets in Asia and Latin America.

Distressed M&A. When dealing with a financially distressed seller, buyers rarely have a problem negotiating favourable indemnity terms. The concern usually lies with the buyer's lack of confidence in the ability to collect on the indemnity if the seller slips into insolvency after the deal closes. In these situations, a RWI insurance policy that can cover potential loss may give the buyer the needed comfort to close the deal.

The 'deal-killer' issue. Everyone in the M&A community has been involved in a deal where a critical issue has arisen, often on the eve of closing, threatening to derail the deal. It could be a potential tax issue, pending litigation or a contingent liability, but in many cases an insurance solution might be available to address the exposure. Even in cases where an insurance product does not already exist to address the specific exposure, a creative insurer can often craft a policy to fit the need and help the deal proceed.

Know your options

With the evolution of M&A insurance products, all deal professionals should become familiar with the various insurance tools at their disposal. It could very well be the key to getting your next deal done.

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