

The onset of the global financial crisis has made it more difficult to get mergers and acquisitions (M&A) across the line. Volatility is bringing a new level of insecurity to transactions so companies are looking to insurance to bridge the uncertainty gap. By **Sue Copeman**

Bridging the M&A uncertainty gap



Mergers and acquisitions (M&A) in respect of cross border transactions increased in 2010 for the first time since the beginning of the global financial crisis in 2008 and continued to perform well going into the second quarter of 2011, according to the Organisation for Economic Co-operation and Development (OECD).

Teresa Jones, a Partner at JLT Specialty, states that deal activity has fallen off significantly in this last quarter of this year due to economic uncertainties in Europe and continuing pressure on borrowing. However, whilst the outlook remains uncertain there is undoubtedly significant capital sitting on both corporate balance sheets and within private equity funds that they are keen to invest in strong assets.

Buyers' caution is reflected in a preference for insurance. "No one wants surprises, evinced by the fact that the number of insured deals reportedly increased by a third in the last year," says Jones. "Our feedback from

underwriters also suggests that the number of buyers taking out insurance – as opposed to sellers – has increased by about 50 per cent over the last three years. Buyers are looking for more certainty about the assets they are acquiring," she comments.

Jesseman Pryor, CEO of the US-based Ambridge Partners LLC, adds that banks are cutting back on financing buyouts because they perceive this as riskier than other types of lending. "Buyers are finding that the purchase of insurance can address potential exposures that may impact the target's future prospects. Increasingly, we are seeing that a condition of the acquisition financing is that insurance is put in place to address these potential exposures," he says.

Insurance responds

Adam Codrington, a Partner at JLT Specialty, says that the insurance market has responded to increased interest by more competitive pricing and a willingness to tailor cover to meet the needs of specific deals. "Premium rates for warranty and indemnity (W&I)

insurance have fallen by as much as 60 per cent in some cases, so the price of insurance represents a much smaller proportion of the costs of the transaction, the fact that coverage is generally broader and aligned specifically to the underlying M&A deal makes a big difference," he explains.

Pryor agrees that covering those issues that have potential to cause significant problems is more cost effective than buying an 'all in' policy for all warranties, indemnities and tax exposures.

Andrew Graham, Vice President and European Manager of the Mergers and Acquisitions Insurance Group at Chartis, says that Chartis also provides tax liability insurance and contingent liability insurance, but its most widely used product is W&I Insurance. As one would expect, this product sees the highest claims frequency. "Some 35 per cent of claims involve allegations of breaches of warranties given by a seller in relation to accounts warranties," he says, adding that environmental warranties and intellectual property warranties also give rise



Insurance can help bridge the gap between seller and buyer in negotiations

Liability divergence

In some cases, buyer and seller may be unable to agree the warrantor's liability cap in the event of a breach of warranty. The eventual figure depends on the strength of the negotiating position of the respective parties. If the buyer feels that the amount of recourse is too low, insurance can top up the level of cover. "W&I insurance is often used as a tool to resolve deadlocks in negotiations between parties on a transaction," explains Graham.

A buyer may also be concerned about its ability to enforce a claim for breach of warranties against the seller, perhaps due to uncertainty as to the enforceability of a claim in the jurisdiction where the seller is located or where there are doubts over the covenant strength of the seller. Crucially, the buyer does not have to bring a claim against the seller before it can seek recourse under the insurance policy.

In addition, it is not uncommon for private equity institutions to use W&I insurance to distinguish their bid in a competitive auction. "We have worked closely with private equity institutions in deal situations. By agreeing in principle the terms of a buyer-side insurance policy before they enter the bid process, they can obtain a competitive advantage against the other bidders by offering an attractive purchase price but only requiring a low warranty cap from the seller," says Graham.

Other types of potential deal breakers can also be protected. Codrington gives the example of unresolved litigation against the target company.

He points out that insurance in respect of cross border deals can be particularly valuable. "Buyers may be almost totally reliant on the advice they receive if they have no direct experience in a country. Insurance protection can help mitigate the exposure that they suspect might exist." Certainly the purchase of M&A insurance has become more wide ranging. Jones cites the UK, USA, Australasia, Germany and the Nordic countries as being particularly active in this area. **RS**

to a disproportionate number of claims.

For a buyer of a company, W&I insurance can be an attractive option. "We see the product being used by buyers to supplement the coverage they receive from a seller in terms of quantum, duration and certainty of payment," Graham says. "For a seller, insurance can reduce the risk of contingent liabilities arising from future claims, allowing a seller to exit a business cleanly. We see a number of private equity sellers using the product as a tool to distribute all or most of

says. "Insurance allows the seller to achieve a clean exit and to distribute the money from the sale without having to wait until these periods have expired."

Pryor stresses that M&A cover gives buyers certainty in developing their financial model for the acquired or merged company. "For example, while a tax adviser may opine that there is only a remote possibility that a potential tax liability will crystallise, their opinion is not binding on the tax authorities. As tax enquiries often take many years to

conclude, the interest on a potential tax charge of, say \$50 million, could double the amount payable by the time an enquiry has been resolved. In the absence of insurance, a tax charge of such magnitude could destroy the whole economics of the transaction," he explains.

Tax insurance can be particularly valuable where a transaction involves private equity buyers, adds Pryor.

"Given that the holding period for a PE investment is often five years or less, "covering off" a potential tax exposure with tax insurance at the time a business is purchased can prevent that exposure from becoming a deal point if it is still unresolved at the time the buyer decides to exit its investment."

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Teresa Jones, Partner at JLT Specialty

the sale proceeds to investors and avoid the need for an escrow account."

Insurance can be an attractive option for a number of reasons. "In respect of warranties on the state of affairs of the business, buyers usually negotiate a term of two years within which they can bring a claim for breach, and a term of seven years for tax claims," Graham

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Global M&A transactions

The M&A landscape is very different around the world, with insurance playing a different role in each region.

UK

As turmoil in the eurozone takes its toll on the UK, M&A appetites are understandably affected. Nevertheless, some activity is continuing, although buyers are more cautious.

The M&A insurance market in the UK is already quite well developed, in part because of very reasonable costs, although both buyers and sellers are often unaware that M&A policies can be used as deal facilitators. There is currently a high degree of uncertainty and, depending on economic factors, the increasing uptake of insurance is set to continue.

Case study: Seller's W&I insurance

The CEO of a privately held UK engineering business being sold to a large US corporation, who was retiring upon completion of the sale, was being required to give warranties with a financial cap set at the purchase price of around £15 million.

Whilst the CEO was confident the warranties accurately reflected the state of affairs of the business, he was concerned that the purchaser was a considerably larger entity from a more litigious society.

JLT was able to put in place a seller's W&I policy with a £15 million policy limit. The deal successfully completed, and the CEO was able to enjoy his hard-earned retirement fund, safe in the knowledge that his liabilities had been ring-fenced.

Europe

Very large deals have become rare although smaller M&A transactions are still continuing. But Patrick Forslund of Swedish law firm Vinge says that M&A transactions are generally taking longer to arrange than before. "A big obstacle is financing. However, terms and conditions are more onerous than before, margins have increased and the amounts available to borrow are lower."

Case study: Real estate buyer's W&I insurance

A quoted real estate company was looking to buy a portfolio of real estate assets from an investment fund which was being liquidated for approximately €500 million.

The fund owners and the financing banks were initially only willing to offer title and capacity warranties with no escrow. The buyer needed a standard set of warranties to comply with internal M&A procedures and protect shareholders' interests.

JLT introduced the concept of a buyer's W&I policy that would enable the seller to give a full set of commercial warranties but with a nil cap under the sale and purchase agreement. The insurance policy wrapped around these warranties and gave the buyer the investment protection it was seeking whilst also enabling the seller to make a clean exit on closing.

The insurance policy limit was €50 million at a premium of €650,000 for a six-year period to mirror the expiry of the tax and environmental liability warranties.

Asia

Both buyers and sellers are waiting for resolution of economic problems in Europe. Many deals in the first half of 2011 involved private equity exits but there was also activity in the energy and resources sectors.

Buyers and sellers in Asia are beginning to use M&A insurance, particularly as pricing makes it more accessible, says Joshua Cole, Partner at Mallesons Stephen Jaques.

Case study: Seller's liability insurance

An Asian publicly listed company selling an Asia Pac subsidiary was providing a financial warranty cap equivalent to the total purchase price.

JLT placed a seller's liability policy for a significant limit to provide the seller with balance sheet protection. The cost of the insurance was slightly more than 1 per cent across the entire programme for a 6-year policy.

Australia

M&A activity in Australia is growing. Many transactions involved the energy, mining and utilities sectors, says Joshua Cole, Partner at Mallesons Stephen Jaques. Companies have taken some time to become accustomed to using insurance but now its proportionate use is higher than any other territory.

Case study: Buyer's W&I insurance

A European company was bidding for a A\$100-million Australasian business. The sellers, both financial investors and management, were willing to provide warranties in the sale and purchase agreement and disclose against them, but were unwilling to take on any financial liability so these warranties were to be given with a nil cap.

The company was in an auction process and keen to close the deal, but it was unable to proceed with no financial recourse in the event of a warranty claim. It was mindful that insisting on a meaningful warranty cap from the seller could lose them the deal.

JLT provided an option for a buyer's W&I policy for A\$25 million at an A\$300,000 premium that was used in its final bid offer. The deal was successfully closed with the cost of the premium a purchase price adjustment.