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TRANSACTIONAL INSURANCE

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HOT TOPIC

TRANSACTIONAL INSURANCE

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R&C: Could you provide an overview of the types of transactional risk insurance and why any of those products might be needed in an M&A context?

Cosentino: There are three products we generally talk about in the context of transactional risk insurance: representations and warranties insurance, tax liability insurance, and contingent liability insurance. Each can be used to protect the parties in an M&A transaction from potential liabilities in the underlying deal, otherwise the buyer or seller will need to assume these risks. Additionally, the allocation of these risks between the buyer and seller can become cumbersome and lead to protracted negotiations or the deal falling apart. The products allow buyers and sellers to efficiently shift the transaction risks to an insurer. This can enhance the deal value for each party, make the transaction process somewhat less adversarial, and facilitate a more orderly and expeditious close.

R&C: How would you describe the growth and take-up of transactional insurance in recent years? Which trends would you highlight?

Conroy: The products were initially slow to catch on, but about six years ago they really took off with private equity buyers. That success was largely attributable to a lengthy educational campaign by various market participants, explaining to potential purchasers and their counsel how the products worked and helped facilitate deals. Although the initial growth was attributable to private equity buyers, in the last 12 to 18 months the market has seen growing interest in these tools among strategic buyers.

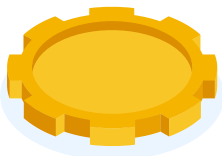
Addy: 2018 was another banner year in terms of aggregate deal value. Given the adoption of the products among 'strategics', the breadth of adopters, number of transactions and adoption rates have all contributed to increased placements of these policies. In addition, quite a few new participants have entered the market in the last 24 months. This has resulted in policies covering industries that might not have been previously considered, like healthcare and financial institutions. Another exciting trend is the ability to move beyond the middle market to provide transactional risk solutions to both larger and smaller deals.

R&C: Could you provide additional insights into the benefits of transactional risk insurance solutions and how they are being utilised?

Cosentino: First, let's look at representations and warranties insurance, as this is the product most utilised in an M&A context. As the product's

name suggests, the insurance provides protection against losses arising from unintentional and unknown breaches of the representations and warranties regarding the seller and target business included in the acquisition or merger agreement. Regardless of due diligence, there is always the possibility of an unidentified exposure coming to light post-transaction. In such cases, the buyer may claim "This was not how the matter was represented". The potential for such unknown exposures exists in every M&A transaction. The insurance protects both buyers and sellers from these unintentional and unknown exposures.

Addy: With regard to the contingent liability product, potential exposures like the possibility of employment disputes, environmental liability exposures, intellectual property infringement claims, or other litigation liabilities can potentially be 'collared' with the policy, removing them as concerns during the negotiating process. Traditionally, the allocation of these contingent liabilities is a matter of extensive negotiations, involving complicated indemnities and escrow arrangements that ultimately affect the purchase price. The contingent liability insurance provides more certainty to both buyers and sellers about what the future exposure may be, facilitating negotiations around how it should be addressed.



R&C: What are the key benefits of a tax liability policy in the M&A process?

> **"The tax liability product addresses a company's known tax exposures. As such, it can be particularly helpful in an M&A context."**
>
> *Gregory Conroy, Chubb*

Conroy: The tax liability product addresses a company's known tax exposures. As such, it can be particularly helpful in an M&A context. If a tax regulator challenges a tax position after the original tax filing, it can result in significant liabilities for a company to the extent the challenge is successful. This scenario is not uncommon, given the inherent complexity and ambiguity of certain tax laws. The tax liability insurance product is designed to address that uncertainty, taking the matter off the table so the deal can proceed accordingly. If a company is on the block

for a sale, buyers may identify certain tax exposures they want to preserve treatment on. In the event the tax position is successfully challenged, the insurance would limit the downside. That is one example of how a policy might facilitate the transfer of risk for a potential tax issue.

R&C: How have policies changed in their coverage terms, conditions and pricing, and in response to growing market demand?

Cosentino: With regard to the reps and warranties product, more carriers have entered the market, increasing the aggregate financial capacity to assume these risks. Competition in recent years has driven broader policy coverage terms and conditions and higher limits of financial protection. Equally important is that the retentions – similar to deductibles – have come down in the past couple years. All of these factors have spurred increases in the adoption rate of the product, particularly as more buyers and law firms become comfortable with their varied benefits in an M&A context. In addition, the market as a whole has a better understanding of claims experience, another key factor in the growing adoption rate. There are more market entrants, resulting in broader coverages, with some insurers moving to cover a wider set of tax liabilities, such as foreign taxes. Contingent liability policies, on the other hand, are the least common, as the question of what exposures insurers are comfortable covering, able to cover and to what extent, are complicated and quite fact specific.

"Competition in recent years has driven broader policy coverage terms and conditions and higher limits of financial protection."

Joseph Cosentino, Clifford Chance

R&C: To what extent can transactional risk insurance enhance M&A due diligence?

Cosentino: To analyse coverage to be provided under a transactional risk policy, the insurer will review the due diligence conducted by the insured's internal deal team and external advisers into the exposures that are the subject of the representations and warranties included in the merger or acquisition agreement or other exposures to be insured. In

conducting this review, the carrier will request written reports and other formal documentation from the deal team and external advisers and will engage in a detailed discussion with them regarding the diligence and transaction process. This review is designed to ensure that all material risks have been thoroughly investigated, assisting an expanded dialogue between the buyer, the seller and the various advisers. More probing questions are asked, furthering the scope of the due diligence. Of course, this process cannot replace the respective parties' due diligence efforts and obligations, but by identifying and discussing risks that may not have been reviewed otherwise, due diligence can become even more rigorous, standardised and effective through this process.

R&C: What essential advice would you offer to buyers and sellers evaluating transactional risk insurance? What aspects do they need to consider?

Conroy: First and foremost: communicate. Talk to insurers and brokers as early in the process as possible. This way everyone is on the same page with respect to the due diligence scope and process, the potential exposures and how those exposures can best be mitigated. The possibility of unknown exposures, for instance, can be mitigated through the representations and warranties coverage, while the known exposures may be 'collared' through the tax indemnity and contingent liability products.

Addy: Because many of these risks are of a long-tailed nature, a key consideration is the financial strength of the insurance provider. You should deal with an insurer that has a strong balance sheet, a history of fairly paying claims and experience underwriting transactional risk insurance.

"Because many of these risks are of a long-tailed nature, a key consideration is the financial strength of the insurance provider."

Colin Addy, Chubb

Cosentino: It is also important for buyers and sellers to understand that their due diligence needs to be just as thorough as if no insurance were involved. Another piece of advice is to keep an open mind. Although there are exposures that may not lend themselves to insurance coverage, do not assume this to be the case. With the market growing

and coverages broadening, more experienced insurers are creative in addressing a wider range of issues. In this regard, work with a good insurance broker and talk with carriers about your concerns – you may be surprised about the range of exposures that can be mitigated through insurance.

R&C: How do you expect the transactional risk market to evolve in the years ahead? Will competition compel additional innovation and differentiation?

Conroy: We are already beginning to see enhanced interest in insuring M&A risks in complicated sectors like healthcare, an industry difficult to insure in the past. Carriers are bringing in the expertise needed to mitigate the sector's complex exposures. R&C