Emerging Risk Considerations in Global M&A Transactions

Cybersecurity and Transactional Risk Among Key Concerns

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In this fast-paced, high-stakes M&A environment, private equity dealmakers are faced with unique and growing financial exposures.

Global Mergers and Acquisitions (M&A) transactions tallied up to an impressive $678.5 billion in deal value in the first quarter of 2017, up by 8.9 percent year over year, according to Mergermarket's most recent estimates.[i] Although the number of M&A transactions fell, the substantial deal values indicated growing interest in mega-deals (e.g. transactions with a deal value in excess of US $10 billion). The volume of such mega-deals has reached record heights, accounting for 54 percent[i] of all completed transactions.

This uptick in deal value is not a phenomenon specific to 2017. Total M&A activity in 2016 was $3.6 trillion, the second highest yearly total on record since the 2008 financial crisis. The outlook among many investment banks is for continued growth in global M&A deals through the remainder of 2017. In the United States, private equity-backed M&A activity alone was up 340 percent in mid-February from the prior year period, according to Thomson Reuters.[ii]

In this fast-paced, high-stakes environment, private equity dealmakers are faced with unique and growing financial exposures. In this paper, we address three such concerns inherent in M&A transactions: cybersecurity risks, transactional risks and multinational expansion risks. For each of these concerns, the use of a specialized risk transfer mechanism is valuable for the transaction to proceed with greater clarity and confidence.

Of notable concern: successful cyber attacks are expected to increase in the future.

Cybersecurity Concerns

Private equity dealmakers confront significant issues over the cyber exposures of a target acquisition. Last year was the worst on record for cyber attacks, with nearly half of all businesses held captive by ransomware incidents alone, according to a survey by Osterman Research.[iii]

Companies of all sizes have experienced data breaches, from the largest enterprises to main street businesses. The categories of cyber attacks are also multiplying, as are the types of attackers, which include hacktivists, criminal enterprises, and even possibly nation states.

Of notable concern, successful cyber attacks are expected to increase in the future. Attackers are proving to be more sophisticated in their use of social engineering techniques, cleverly inventing new phishing scams that lure people to click on malware-infected attachments. Many companies are also rapidly embracing new technologies that broaden their exposure, including machine learning, augmented intelligence, natural language processing, big data analytics, robotics, and the Internet of Things. A forensic analysis of a target acquisition's cyber risks that was performed during due diligence may no longer provide a credible assessment of the company's exposure after the deal closes.

Even as the ink on the transaction agreement dries, the merged entity's cyber exposures generally increase. As the two organizations begin the process of combining networks and multiple systems, their respective data at specific intersection points are vulnerable to an attack. The reason is the need to temporarily remove the filters at the intersection points to permit data to flow from one system to another.

Other factors can also contribute to the combined entity's enhanced cyber risk profile. Each party's cybersecurity protocols may be dissimilar, and they will need time to determine which practices will remain in place, potentially leaving the combined organization exposed to security gaps in the interim. Phishing-related data breaches post-merger also tend to rise because each company's employees are unsure over the authenticity of emails or other communications they receive. Cyber criminals are very cognizant of these post-transaction vulnerabilities.

The growing concern over cybersecurity is compelling investment managers like Morgan Stanley to conduct more thorough due diligence of a potential acquisition's cyber risks to gauge the impact on post-transaction value.

"We've always done technical due diligence, tax due diligence, legal due diligence, environmental liability due diligence, and so on, but it is now just as important to conduct cyber due diligence," said William Penley, Executive Director, Morgan Stanley.

Even the best due diligence may not uncover the full extent of a target acquisition's cyber risks, given the rapid growth in the number and types of sophisticated cyber attacks. One way to mitigate such risks is to seek cyber insurance from insurers that specialize in M&A transactions. These insurers typically provide a range of different cyber insurance policies to absorb a broad array of cyber risks, in addition to multiline cyber peril endorsements that address gaps in an insurance portfolio placed with multiple brokers and carriers.

Some insurers also offer a variety of valuable loss control services as part of their insurance programs. These services may include comprehensive cyber risk assessments, continuous detailed threat intelligence and analysis, and post-incident forensic and crisis management assistance. Thus, the right cyber coverage along with associated risk management services can help identify and mitigate this evolving risk.

Transactional Risk Concerns

In the private M&A context, many purchase agreements require the buyer to procure a Representations & Warranties insurance policy. This type of insurance provides protection against financial losses as a result of certain unknown breaches of the seller's representations and warranties made in the purchase agreement.

Representations & Warranties insurance is available for both sellers and buyers in an M&A transaction, and it facilitates more predictable M&A outcomes by protecting deal participants from financial exposures discovered during the post-closing integration. This unique insurance policy has caught on widely as a key M&A risk management instrument over the past five years, and is routinely secured now by private equity buyers.

Utilizing Representations & Warranties insurance as a risk management tool is a compelling alternative to the traditional use of escrow or other seller indemnity. "We've used the Reps & Warranties product not because we had a specific concern with the related risks, but in order to be able to basically shut down the (escrow) fund," said Mr. Penley.

"The operational cost of running an open fund, given the surrounding accounting, treasury and legal obligations, is significant. Without this product, we'd have an open liability that would require us to maintain these entities. In addition, it is a great tool to assist the deal team when negotiating."

The latter point resonates. For example, in a situation where two bidders are each offering $100 million to acquire a company, bidder A may request the seller to keep $10 million in escrow, whereas bidder B, who has procured a Representations & Warranties policy, may ask it to retain $1 million in escrow. Putting up $10 million is less attractive to a seller, given the temporary loss of use of this capital now in escrow to cover potential breaches of representations and warranties. The buyer's procurement of a representations and warranties insurance policy gives the seller the opportunity to reduce the escrow amount, making bidder B's offer more attractive.

Other benefits of Representations & Warranties insurance for sellers and buyers include:

- **Peace of Mind for a Longer Period of Time** – A Representations and Warranties insurance policy for a period of three to six years as compared with the typical twelve to eighteen month duration of escrow funds or other form of seller indemnity.
- **Increased Liquidity** – Sellers can more quickly distribute greater portions of the purchase price to their investors in a private equity context or retain these proceeds in an owner/operator context.
- **Reduction of Party Friction** – Key relationships are preserved by mitigating the potential need for a buyer to pursue claims against management sellers working for the buyer post closing.
- **Secured Indemnity** – In addition to risk transfer, buyer is relieved of the credit risk of seller that buyer would be exposed to absent the Representation & Warranties insurance.

The advantages to procuring a Representations & Warranties insurance policy are significant: helping both buyers and sellers facilitate time-sensitive, document-intensive closing of private equity firms' M&A transactions by removing the deal friction inherent in these types of transactions. Because of this, consideration of a Representations & Warranties insurance policy is suggested for all M&A transactions.

Once the transaction closes, the buyer typically assumes the target entity's liabilities, which can include exposures from decades past.

Multinational Expansion Risks

In today's highly uncertain geopolitical climate, M&A activity that involves foreign multinational entities is subject to rapidly evolving regulatory, legal and compliance issues. The shifting compliance landscape in many countries increases the need for comprehensive due diligence to evaluate complex post-transaction integration issues. While many buyers carefully assess a multinational target's financial statements, customer base, technology infrastructure, and contractual obligations, often less consideration is afforded the entity's insurance policies.

From a due diligence standpoint, sifting through a multinational company's insurance policies to address the risk of unforeseen liabilities and insurance coverage gaps can be an exhaustive exercise. Consider, for instance, a target entity had acquired numerous businesses through the years, some of which no longer existed. Which insurance policies, if any, addressed these legacy companies' liabilities? If these risks are not identified during the due diligence period, they could create latent liability issues for the acquirer – potential surprises that were not accounted for in the purchase and sale agreement, culminating in unanticipated financial exposures and possible financial losses. Once the transaction closes, the buyer typically assumes the target entity's liabilities, which can include exposures from decades past.

Equally concerning is the adequacy of the scope of any insurance coverage available under existing insurance policies. What if the entity's local (admitted) insurance policies are insufficient to absorb past and prospective employment, property, commercial automobile, environmental, and political risks? These insurance policies may contain regulatory exclusions, coverage gaps, or inadequate financial limits of protection to effectively absorb these wide-ranging liabilities. Some policies may have converted into run-off mode, meaning the coverage provided is only for a short period of time. Even worse, the policies may have ceased to provide any coverage at all.

Few risk managers have the time or expertise necessary to undertake a comprehensive review of a multinational company's legacy liabilities, which may be decades old and could involve dozens of previous acquisitions. They would need to scrutinize possibly hundreds of insurance policies absorbing myriad risks in wide-ranging geographic locations, each governed by a unique regulatory regime. Simply translating a policy into English can require extraordinary effort.

By purchasing a Controlled Master Program (CMP), private equity buyers can address some of these risks. A CMP pairs a master insurance policy issued in the United States to the U.S. parent with local (admitted) policies that are issued around the world. In effect, the CMP absorbs the potential inadequacies of the target entity's insurance policies, closing insurance gaps with "difference in conditions" and "difference in limits" provisions in the master policy, while maintaining the local insurance policies in force.

A CMP also may assist a private equity buyer to obtain possible tax benefits, as locally paid premiums and insured losses are often tax-deductible. A CMP coordinates all the insurance policies in one place, helping buyers achieve administrative efficiencies, possible premium savings, and other cost-efficiencies due to the economies of scale.

Morgan Stanley understands these benefits, and purchases a CMP covering its real estate M&A fund activities. "We do a master program by region and line of insurance, and they prove to be at-market or better in each jurisdiction than what could be secured locally," Mr. Penley said. "There is certainty and uniformity of coverage. And by purchasing the CMP from a single insurer, you have an established relationship with that carrier. This is quite helpful in the event there is an unforeseen event and the claim is not black and white."

The Right Provider

These unique M&A risk management and risk transfer opportunities for private equity firms should be given thorough consideration, particularly as transaction activity and values are projected to continue to increase in the months ahead. These M&A risk transfer solutions further affirm the prudence of partnering with a specialized insurance carrier to achieve projected deal value.

In the current competitive M&A environment, private equity firms often need customized assistance from a specialized insurance carrier to comprehensively assess and address a target entity's complex liabilities. Firms should consider the services and products of an insurer with a broad product portfolio to absorb all post-transaction liabilities.

The provider should possess the responsiveness needed to facilitate the closing of a transaction within a set timetable, removing or minimizing the prospect of unexpected and uninsured surprises.

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With over 20 years of experience in financial accounting and insurance risk management, Mr. Penley currently oversees the MSIM Private Funds. Prior to joining Morgan Stanley in 2009, Mr. Penley spent 13 years at Goldman Sachs & Co. in a variety of roles including real estate financial controller, merchant banking risk manager and reinsurance financial management. Previous to that role, Mr. Penley was an auditor at PriceWaterhouseCoopers.

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Endnotes

i MergerMarket 2017 Q1 Global M&A Trend, April 2017

ii Thomson Reuters, Private equity is driving M&A in 2017, February 2017

iii Osterman Research, Understanding the Depth of the Global Ransomware Problem, August 2016

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