TRANSACTION INSURANCES ON INTERNATIONAL DEALS

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When you consider a deal outside of the U.S., you must familiarize yourself with differences in legal system. Contractual behaviors and market conditions, including instructing local counsel, familiarizing yourself with a different legal system, different contractual practices and different enforcement mechanisms. Transaction insurances are becoming increasingly common tools to reduce M&A deal risks.

However, these products are widely misunderstood. It is vital that, before you pay the premium, you fully understand the product and obtain value for it.

Transaction insurances have unlocked many an impasse on M&A deals but are also changing behaviors and risk tolerances. There is a growing and concerning complacency in the market that it is not necessary to fully negotiate the deal, because the risk will be covered by the policy: this is simply not the case, as anyone who has sat on an underwriting call will testify.

This article represents an overview of transactional insurance on M&A deals, drawing upon current and emerging trends on both sides of the Atlantic.

TRANSACTION INSURANCE, SO YOU MEAN R&W INSURANCE?

Not quite. In the U.S. and Canada, the product is called representation and warranty insurance (RWI), reflecting the fact that buyer protections are usually presented in the form of a series of representations. By contrast, in Europe the product is called warranty and indemnity insurance and requires a contractual warranty claim to be brought for proven losses. These differences in terminology are reflected in differing risk coverage and, when combined with a less litigious culture, lead to very different cover premiums. You will find European cover costs to be significantly lower than those in North America.

WHEN MIGHT A TRANSACTION INSURANCE BECOME APPROPRIATE?

- High deal value
- High complexity
- Seller wants to distribute cash immediately (e.g. a fund)
- Expectation gaps on buyer protections
- Multiple vendors
- Alternative to a retention or escrow
- Parties need to rely on the strong covenant of an insurer

ADVANTAGES OF TRANSACTION INSURANCE

There is a perception that obtaining transaction insurance on M&A deals increases cost and time. In fact, experience shows that it can actually accelerate deals getting to closing, ending often soul-destroying and negative negotiation where lawyers hunker down in the negotiating process.

RWI allows the buyer to rely on a policy that offers more protection than what the seller may be willing or able to offer via traditional indemnification and may extend the survival period of the reps, offer higher limits of indemnification, and provide a buyer the opportunity to file a claim with an insurer as opposed to suing the management team they just acquired in the event of a breach.

One of the reasons RWI is rising in popularity is its flexibility, through delivering benefits to each the buyer and seller, regardless of which party is the named insured or pays for the premium. RWI policies offer the most protection when the terms of the transaction agreement are balanced as a result of comprehensive, but reasonable, negotiation and don't heavily favor one party over the other. Further, the policy can be tailored to match the risk profile of the transaction. For example, if the target has significant IP exposure, when a breach would exceed the general indemnity cap, a policy holder can purchase a separate, higher limit for those provisions.

RISKS WHICH REMAIN WITH THE SELLER

The insurer perceives risks, their materiality and whether or not these should be borne, very differently from the parties. Underwriters will not simply agree to cover the negotiated SPA. Instead, a key part of obtaining the policy is a granular analysis of each warranty and a schedule setting out whether each is:

- covered;
- not covered; or
- modified.

This is where things can become a little metaphysical. You will have a choice to renegotiate the warranty or proceed on the basis of a non-real scenario, like a hypothetical lease on a rent review.

It is vital to work with your broker and to draft the stock purchase agreement in such a way that it is clear that the seller will bear risks not covered by insurance (insurers generally exclude cover for unspecified environmental and tax risks, certain deal-specific indemnities). It is also important to remember that insurance is unlikely to be effective in relation to criminal liability as a matter of public policy.

GETTING THE POLICY IN PLACE

You cannot speak to your broker too soon. The broker understands the current market and where risk appetite lies , even with a forward view as to attitudes 4-6 months ahead, when the deal will close. For example, many environmental risks will not be covered by the product and certain specific tax risks (in particular, for tax planning) are likely to be excluded. This allows you to go into the negotiation fully armed with an understanding of what you can get covered by insurance and the areas where you will require the seller to go on risk. Your broker can also offer advice on the diligence that underwriters will expect to see given the risk profile of your transaction. For example, if the target has unaudited financials, the underwriters will most likely require a quality of earnings report prepared by an auditor and this can take a few weeks to prepare.

Experience shows that it takes 5-6 weeks to select an insurer, negotiate terms and the cover schedule with its legal team and take on board the insurer's comments on the SPA. Accordingly, the reality is that transaction insurance represents no delay to a deal, because it can be run in parallel with the due diligence, negotiation and disclosure processes. It is vital to ensure that you have effective transaction and project management in place, otherwise you will experience inevitable delays.

The decision to purchase an RWI policy is often made once negotiations have stalled and the transaction is well underway. While not ideal, underwriters can and will get a policy in place within a fortnight. Additionally, you can even place a policy for a transaction after closing but at that point the terms of the agreement are final, so the underwriters' flexibility on certain terms will be limited.

THE ADVANTAGES FOR A SELLER

Generally, in M&A transactions, the representations and warranties are about the buyer's desire to understand the target company that it has seen in the due diligence review process, to ensure the portrait remains true at closing and to attribute risk if this is no longer the case.

The seller is generally looking to avoid giving assurances on issues it does not have direct knowledge or experience of, particularly risks that are already known to the buyer.

Where the parties end up as to the apportionment of risk is often a function of different elements, including the bargaining power of the parties, the skill of their advisors, the depth and breadth of the due diligence review that was conducted and the time period available for the due diligence review.

In this context, the advantages for the seller of transaction insurance are multiple. For instance, the policy may be used to:

(i) extend the scope of certain representations or warranties to bridge the gap between the needs and expectations of buyer and seller;

(ii) bridge the gap between the seller and the buyer regarding the amount of the holdback of part of the purchase price payable at closing and the duration of such holdback; and

(iii) resolve issues of joint and several liability, which can become problematic where

there are shareholders with different levels of knowledge of, or investment in, the target company.

THE ADVANTAGES FOR A BUYER

The buyer is risking its capital and wants to hold some back rather than have to sue (potentially many individual shareholders) for a breach when the asset does not live up to the promises made. However, often the seller is not prepared to give the comfort the buyer needs.

As a result, for the buyer, the advantage of transaction insurance is that it can deliver the certainty to complete. In addition, insurance (and the involvement of an objective third party analyzing the deal in a different way to the parties) can help ease the potential conflicting interests that arise in certain types of transactions where one or more of the sellers are:

- insolvent or financially distressed;
- employees of the seller;
- being hired to manage the purchased business post closing; or
- rolling over a portion of their ownership interest into the buyer.

POTENTIAL PITFALLS

Despite the potential advantages, the use of insurance is not without risks and there are optimal size parameters within which this product works best.

It is not uncommon for sellers to indemnify against issues that are known to the buyer, and such matters to not be insurable. It is best to involve your broker as soon as possible.

The contract of insurance itself can be a pitfall. These are not the type of documents transactional lawyers are expert in analyzing. Simply lining up the definitions and the carve-outs and exclusions in the policy with the purchase agreement can be challenging, hence the need to work with a good broker, who will usually deploy a transaction team, including legally qualified experts in these products.

Many underwriters have pre-negotiated base forms. Prior to the release of the first draft policy, your broker should be pushing the underwriter to use the most recently negotiated policy form to avoid unnecessary revisions.

It is important for parties to understand that these insurances are not a cure all and risks remain with buyer and seller as allocated under the contract or by law.

For example, there is often a deductible, which means that the seller will have to cover a portion of the loss claimed in addition to having paid the premium (assuming it was not paid by the buyer or split between the parties).

In addition, there will be certain types of liability that are excluded from the policy. There are, however, other transactional insurance products available in the market to address some of these issues such as a tax opinion or contingent liability policy. A tax opinion policy will cover certain tax treatments that are standard exclusions in an RWI policy. Additionally, other transactional insurance products will cover known risks and are commonly used outside the context of a transaction.

Understanding the scope of the remaining risk and communicating this to clients is an important responsibility of the M&A attorney. No attorney will be thanked by his or her client where the client believes cover has been obtained, but the policy does not pay out on the specific risk in question.

THE CURRENT STATE OF THE PRODUCT

Transaction insurances have long been used to plug title issues on real estate deals. They are now becoming a standard consideration on complex or expensive M&A deals. It is now becoming standard practice to insure deals involving:

- competing bids;
- private equity exits;
- real estate special purpose entities; and
- trading businesses unless the transaction is between industry players.

However, some parties still do not wish to incur the costs and alter the risk profile in the way an insurance product does.

A SALUTARY LESSON FOR THE FUTURE

The increased use of transactional insurance does not eliminate risk from a transaction. It simply changes that risk. Transaction insurances can unlock a number of impasses in a deal. However, it is important to learn the lessons of the last decade when monoline insurance wrappers over collateralized debt obligations collapsed. The insurance is only as good as the financial strength of the insurer.

OUR KEY RECOMMENDATIONS ARE:

- negotiate a comprehensive M&A deal with the counterparty;
- go into the negotiation having fully explored the options with your broker; and
- if the insurance does not cover this risk, ensure that the seller remains on risk and not limited to a nominal $1 of liability.

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