Insurance Products for Use in Mergers, Acquisitions and Related Transactions: A Brief Primer, by Michael A. Rossi, Copyright 2001, Insurance Law Group, Inc.

Although insurance products specifically designed to be used in the context of a merger, acquisition or similar corporate transaction have been used in the UK for about twenty years, their use has increased dramatically over the past several years, mainly in the US and UK, but also in continental Europe, Australia and other parts of the world. This article is intended to serve as a primer on the subject for those just starting to look into this type of insurance. For those already familiar with this type of insurance, it is hoped that the international comparative aspect of this article—focusing on some of the different aspects of such insurance in the US and UK in particular—will prove informative.

What are these M&A Insurance Products that are Receiving so Much Attention?

The first thing one sees when looking at this issue from an international perspective is that different names are used for these products. The difference lies mainly between whether one looks at the products from a US or UK perspective. However, even within the US and UK, the same products are going by different names.

Accordingly, when thinking of M&A insurance, one should focus on the type of risk intended to be covered and function intended to be served by any particular M&A insurance product, rather than the "label" given to a particular product. With a few exceptions, the type of risk at issue typically falls within one of the following two categories.

Unknown Risks. The first type of risk involves unknown risks. In any corporate transaction, the Buyer wants to know what it is buying. It will therefore require from the Seller a long list of representations and warranties whereby the Seller provides the state of affairs of the business or assets that are being sold. Such representations and warranties can touch on everything from accounts receivables, to tax treatments, to pollution conditions, to pension issues, etc. The full gamut of issues that pertain to the business being bought will be laid out by the Seller so that the Buyer knows what it is buying.

But can the Buyer be assured that it really knows what it is buying? What if any of the representations and warranties by the Seller proves to be wrong, either through fraud on the part of Seller or by innocent mistake? That is a risk inherent in all M&A and related corporate transaction activity. The traditional way to cover that risk is to require the Seller to agree to indemnify the Buyer for a breach of any representation or warranty. But such an indemnity is only as good as the financial solvency of the indemnitor. So, as a matter of practice, a Buyer usually will require some form of financial guarantee from the Seller to ensure that the Seller will

have the funds necessary to perform the indemnity obligation in the event of a breach of a representation or warranty. Such a guarantee can be structured by putting money from the sales price into an escrow account, or by structuring a letter of credit, or by other means.

M&A insurance can serve a variety of functions in such a setting. Such insurance can serve as the entirety of the financial guarantee for the Seller's indemnity obligations, thereby doing away with the need for an escrow account, letter of credit or otherwise. For example, if a Seller's form of Representation and Warranty or Warranty and Indemnity insurance is procured, that insurance will pay on behalf of the insured Seller any indemnity obligations it owes to the Buyer for a breach of a representation or warranty. Such insurance can also be used in conjunction with a reduced escrow amount or letter of credit, or be used alongside an escrow or letter of credit.

In addition, a Buyer's form of such insurance can be purchased, whereby the Buyer is covered by the insurance for a breach of a representation or warranty by the Seller, and the insurer subrogates itself to the Buyer's rights against the Seller for the breach.

Known, But Not Yet Quantified Risks, Losses, Pending Claims, Etc.

What if the risks are actually known, but not yet quantified? For example, what if the Seller is involved in one or more pending claims, but those claims are not going to be resolved at the time of the closing of the transaction? How do the parties to the transaction put a valuation number on those claims in order to structure the transaction?

Likewise, what if there is a known risk with respect to a transaction, where the risk may or may not come to fruition? Such a risk can come in various forms. For example, what if the deal is premised on the assumption that a large portion of the Seller's customers will renew their contracts with Seller, but a review of the contracts show that the customers are not at all obligated to renew the contracts. There is a risk that if a large enough portion of the customers do not renew their contracts after the deal closes then the deal becomes uneconomical for the Buyer.

Or, what if the deal is premised on the assumption that a potential liability of the Seller will not come to fruition? Tax issues are a perfect example. In some deals, the Buyer looks at the way the Seller has treated certain tax issues over the life of the company, or with respect to the pending transaction, and concludes that there is a risk that tax authorities will disagree with the treatment, thereby imposing a tax liability on the Buyer after the transaction.

In either event, if the known risk comes to fruition, the deal that looked profitable suddenly becomes a "bad" deal. M&A insurance can address such known risks. Such insurance can

put a "certain" number on losses associated with such risk, by providing coverage in excess of a self-insured retention for losses associated with the risk. The "certain" number is the self-insured retention and the premium to pay for the insurance. With such certainty, the parties to the transaction typically can determine if the deal makes sense or not to go forward.

It also should be noted that one party to a transaction can very easily use this type of M&A insurance product without the other party knowing about it, with dramatic results for the party using the insurance. When a known but not yet quantified risk arises during due diligence or otherwise during an M&A transaction, the parties typically argue over who will assume the risk of loss. Will it be Seller? Will it be Buyer? When the risk is not yet quantified, how can either party make an educated decision on whether it will assume the risk, and what it will ask for in return?

The answer is provided by M&A insurance. What parties are doing is taking the risk to the M&A insurance market and getting an indication on what it would cost to insure the risk and for what type of self-insured retention. With that information, the party can negotiate an adjustment in purchase price that is dramatically more than the cost of the insurance plus the self-insured retention.

Here is an example. Assume that parties to a negotiation have negotiated a tentative purchase price of £20 million. But the parties discover a known, but not yet quantified risk. The Seller, without the Buyer's knowledge, gets an indication for M&A insurance for a £500,000 premium and a self-insured retention of £2 million. Armed with this knowledge, the Seller tells Buyer that it will assume the risk of that loss, and indemnify the Buyer for same, but only if the purchase price is increased by £5 million. The Buyer agrees. The Buyer either thinks it just avoided a potentially costly risk, or a potential deal killer just got resolved the way it wanted (i.e., that Seller is assuming the risk). But as far as the Seller is concerned, it just made out like a bandit with £2.5 million in added value to the deal (the increase in purchase price minus the premium plus self-insured retention for the insurance).

Is M&A insurance being used like the hypothetical given? From the author's personal experience, the answer is "yes." And the "value" added to some deals far exceeds the hypothetical numbers used (i.e., the author has seen some deals where the value added for the party using the insurance was in the tens of millions of dollars). This is going on so much that some M&A insurance underwriters are calling for a different pricing model to be used for the insurance, so that they get a portion of the "value" added to deals by use of the insurance.

What Names Have Been Given to these M&A Insurance Products?

With a few exceptions, then, the M&A insurance products that are receiving so much attention and going by so many different names pretty much fall within one of the two categories identified above. That said, the names used for the several different products that can be used to insure one or all of the risks described above include the following:

(a) Warranty and Indemnity Insurance (name used mainly outside of the US, referencing a product that can serve many uses, from insuring unknown risks to known but not yet quantified risks, from tax, to pollution to general risks associated with M&A activity);

(b) Representation and Warranty Insurance (name used mainly in the US, to insure unknown risks associated with the representations and warranties made in a corporate transaction document);

(c) Loss Mitigation Insurance (aka Loss Mitigation Units and Contingent Liability Insurance) (name used mainly in the US, to insure known but not yet quantified risks);

(d) Tax Indemnity Insurance (aka Tax Opinion Insurance) (name used mainly in the US, to insure unknown tax risks, or known but not yet quantified tax risks);

(e) Pollution Legal Liability Insurance (used in the US, UK, Europe and Australia; a stand-alone pollution coverage that can be amended to insure the representations, warranties and indemnities in a corporate transaction that relate to unknown environmental liabilities);

(f) Cleanup Cost Cap Insurance (aka Remediation Stop Loss Insurance) (used in the US, UK, Europe and Australia; a stand-alone pollution coverage that can be amended to insure the indemnities in a corporate transaction that relate to known but not yet quantified cleanup obligations);

(g) Mergers and Acquisitions Indemnity Guarantee Bond (name used in the US for a new surety bond product that guarantees an indemnitor's performance of the indemnity obligations undertaken in a corporate transaction);

(h) Aborted Bid Costs Insurance (name used in the US as well as UK and Europe for a product that is fundamentally different than all the products referenced above—this product insures the costs of a potential Buyer whose attempts to acquire a target fall through due to no fault on the potential Buyer's part).

Beyond the Basics

The foregoing describes some of the basic aspects of M&A insurance. To summarize, M&A insurance products can be used to save a deal from cratering – when the parties cannot agree on what form of financial guarantee should be used for indemnity obligations, and when the parties cannot agree on how to "value" a known but not yet quantified risk. They also can be used to add value to a deal – when one party to the transaction agrees to assume a risk for a major increase or decrease in the purchase price, and then off-loads the risk to an M&A insurer. They also can be used simply as a form of due diligence errors and omissions coverage—simply to hedge against the risk of missing something during due diligence.

But is that all that need be known about M&A insurance? In the author's opinion, the answer to that question is "no." Those are just the basics. A full discussion of all that should be known about such insurance is beyond the scope of this article. However, with the space remaining for this article, the author will describe what he perceives to be some fairly interesting aspects of the different ways these products have developed in the US and UK.

Insuring M&A Pollution Risk

One aspect of these M&A insurance issues that fascinates the author is the debate regarding how best to insure M&A pollution risk. Some insurers argue that using a W&I policy is the better solution; other insurers argue that using a stand-alone pollution policy is the better solution. The author is not prepared to declare a "winner" in this debate, but rather will offer the following perceived "pros" and "cons" from his personal experience. Time will tell which products ultimately are used with greater frequency, and will elucidate the reasons for such use.

First, it should be noted that W&I insurance has been used in the UK for about 20 years. Such policies can be used to insure pollution risks associated with M&A activity. Stand-alone pollution policies, in contrast, have only been available in the UK for the last three or so years. And, for the most part, stand-alone pollution policies sold in the UK are Anglicized versions of US forms, sold predominantly by AIG, Zurich and ECS/X.L.

The US market experience is just the opposite. Stand-alone pollution coverages have been available in the US for about 20 years. But Representation and Warranty Insurance and Loss Mitigation Insurance have been available in the US for only about three years.

W&I Insurance for M&A Pollution Risk

With respect to using W&I insurance for M&A pollution risk, there are several perceived advantages. First, it appears easier to ensure that the coverage is coextensive with the indemnity obligations flowing from a breach of a representation or warranty (in the case of W&I cover) or cost overruns (in the case of an LMU). For example, in the W&I scenario, one does not have to worry if the coverage agreement, definitions, exclusions and conditions one typically sees in a stand-alone pollution policy provides coverage for all that a party undertook to indemnify in the deal documents. With a W&I policy, the cover responds to a breach of a representation or warranty that gives rise to the indemnity obligation—thus, coverage should be coextensive with the indemnity obligation.

Second, it might be cheaper to insure environmental risks along with other indemnity risks associated with a transaction by using one W&I product, rather than buying two separate policies—e.g., W&I and stand-alone pollution coverage.

However, there are also some perceived disadvantages to using a W&I product for M&A pollution risk. First, it appears more difficult to insure Buyer and Buyer's Lender along with Seller, especially if the Buyer's form is sold only as a companion to a separate Seller's form.

Second, some Lenders, especially in the US, are familiar only with stand-alone pollution policies, and require the use of pollution coverage rather than W&I insurance. So, for financed-backed deals, pollution coverage might be the only option.

Third, a stand-alone pollution policy can be written to insure ongoing operations at an insured location, whereas a W&I policy cannot. Thus, if post-transaction activities need to be insured, a stand-alone pollution policy might be the best option.

Stand Alone Pollution Policies for M&A Pollution Risk

With respect to using stand-alone pollution coverage for M&A pollution risk, there are several perceived advantages. First, it appears easier to add Buyer and Buyer's Lender to such policies as "additional Named Insureds." This can really help in some transactions, where the parties to the transaction all want to be covered by the insurance.

Second, there also appears to be greater access to environmental engineering expertise when using a stand-alone pollution carrier, which can help in a couple of different ways. Among other things, the author has seen where the parties to a transaction have been very concerned about an issue identified in a Phase I environmental assessment report, but the insurer's environmental engineers have come in to explain why the issue is not really a problem, and can be insured for next to nothing, relatively speaking. Such advice can be critical in helping to get a deal done.

Third, one can insure ongoing operations with a stand-alone pollution policy, so if that is valuable to the insureds, a stand-alone pollution policy is a good solution.

That said, there are some perceived disadvantages to using a pollution policy to cover M&A pollution risk. At the top of the list is the perception that it is harder to ensure that the coverage offered is coextensive with the indemnity obligations undertaken in the deal documents. That is because stand-alone pollution policies are not written to work for M&A transactions. Rather, they must be amended, sometimes dramatically, to work for M&A transactions. Accordingly, care must be taken to compare the indemnity obligations undertaken in the deal documents to the coverage afforded by the policy. It is not enough to make sure that the policy provides "contractual liability" coverage and excepts indemnity claims from the "insured v. insured" exclusion. That just allows the policy to respond to indemnity claims by Seller against Buyer, or vice versa. The question that remains is whether the environmental liability falls within the coverage grant and related definitions, and does not fall within one of several exclusions. Such assurances can come only from a careful review of the deal documents and the insurance policy language, and from careful negotiations with the pollution coverage underwriter, which sometimes is much easier said than done.

Buyer's Forms vs. Seller's Forms of W&I Insurance

On par with the debate regarding what is the best way to insure M&A pollution risk is the debate on whether it is preferable to use a Buyer's form or Seller's form of W&I insurance. Certain carriers definitely have preferences as to which form should be used. The US market is pretty much evenly split between carriers who offer one or the other type of form, or both types of forms.

The UK market has developed differently. SRS Underwriting Agency Limited, for example, which is headed by Eddie Barnes, the gentleman who is credited with creating W&I insurance in the UK some 20 years ago, prefers using Seller's form W&I policies (and can sell a Buyer's form of policy as a companion to the Seller's form – the Buyer's form responds if the Seller's form is rescinded for fraud on the part of the Seller). AIG Europe, in contrast, prefers using a Buyer's form of W&I cover. One of AIG's stated concerns involves the "moral hazard" issue of insuring someone for his or her own fraud or faulty due diligence. One of SRS' stated concerns is that the insurance works best when it is in the form of liability insurance (in the case of a Seller's form), as opposed to first-party insurance (in the case of a Buyer's form).

This debate will continue for years to come. The author is not attempting to choose sides. Rather, he just wants to highlight the debate for readers. The more important point, in the author's opinion, concerns the need to negotiate the policy language and other terms and conditions of coverage regardless of which form is used for a particular transaction.

Concluding Remarks.

In sum, if you play any role, or wish to play any role, in merger, acquisition and related transaction activity for your company or your clients, it behooves you to understand the different M&A insurance products that are being used with greater frequency in the UK, Europe, Australia, US and elsewhere. It also is helpful to understand how the products have developed differently in the US and UK, and how different products can be used to insure the same set of risks. Finally, it is helpful to understand some of the issues that should be considered whenever reviewing the terms and conditions of such insurance. Hopefully, this article has helped shed some light on some of these subjects.

Insurance Law Group
The law firm for the world's risk managers℠

Insurance Law Group, Inc. is a law firm that is dedicated to servicing the legal needs of policyholders in insurance coverage matters. Michael A. Rossi is President of the firm. He has spent more than a decade representing policyholders in various aspects of giving insurance coverage advice, from helping to structure insurance programs and policies to pursuing claims against insurance companies. Copies of this and other articles written by Mr. Rossi and other lawyers at Insurance Law Group, Inc. can be found at the firm's website, www.inslawgroup.com. Mr. Rossi can be contacted by phone at 1-818-649-7654 and e-mail at mrossi@inslawgroup.com