Insurance *products* for mergers and acquisitions

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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 20 years, their use has increased dramatically over the past several years, mainly in the US and UK. Such products have been available in Australia for about the past two years.

I first wrote about one of these products (representation and warranty insurance) in the November 1999 issue of *Corporate Risk*, and about another product (stand-alone pollution cover) in the December 2000 issue.

The uptake of these products in Australia has been slow. But there really is no reason why such products cannot be used in Australia to the same extent they are being used in the US and UK. Increased use will come with time as more professionals come to understand how and why they are used, and through experience get comfortable with the underwriting process.

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 Australian perspective. However, even within the US and Australia, 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.

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 this 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 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. And such insurance can be used to functionally extend the 'survival period' of representations and warranties. For example, assume the seller wants to be liable for only those breaches of representations and warranties discovered within one year after the effective date of the transaction.

But what if such a limitation would kill the deal? A warranty and indemnity insurance policy can be used to save the deal by extending the survival period. For example, the deal document can be revised so that seller is liable for breach of representation or warranty discovered three years after the transaction, to the extent that the warranty and indemnity policy covers the liability. As far as the seller is concerned, it has not increased its liability exposure, but has structured the deal acceptable to the buyer.

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. This is a fundamentally different type of product because it is a first-party policy insuring the buyer, not a liability policy insuring the seller. However, the buyer can accomplish the same things by using a buyer's form of insurance that the seller can accomplish by using a seller's form (ie. increased financial guarantee for breath of warranty, extending the 'survival' period of representations and warranties, etc).

Risks not quantified

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 'value' 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 mayor 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 the 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 selfinsured retention and the premium to pay for the insurance. With this 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 the seller? Will it be the 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. Parties are 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 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 the 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 potential deal killer just got resolved the way it wanted (ie. that the 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 my point of view, the answer is yes – and the 'value' added to some deals far exceeds the hypothetical numbers used.

Names of 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

* warranty and indemnity insurance: a 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
* representation and warranty insurance: a name used mainly in the US to insure unknown risks associated with the representations and warranties made in a corporate transaction document
* loss mitigation insurance (aka loss mitigation units and contingent liability insurance) is used mainly in the US to insure known but not yet quantified risks
* tax indemnity insurance (aka tax opinion insurance) is used mainly in the US to insure unknown tax risks, or known but not yet quantified tax risks
* pollution legal liability insurance is used in the US, UK, Europe and Australia. It is 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
* clean-up cost cap insurance (aka remediation stop loss insurance) is used in the US, UK, Europe and Australia. It is 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 clean-up obligations
* mergers and acquisitions indemnity guarantee bond: a 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, and
* aborted bid costs insurance: a 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.

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, how long the survival period will be for liability for breach of representations or warranties, and/or how to 'value' a known but not yet quantified risk.

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