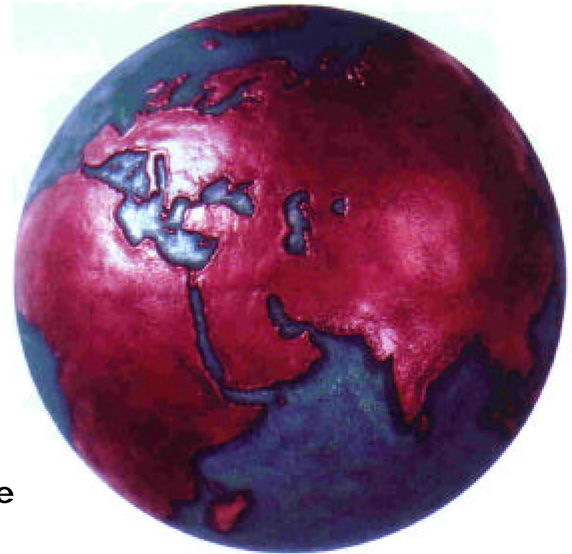
A world of difference



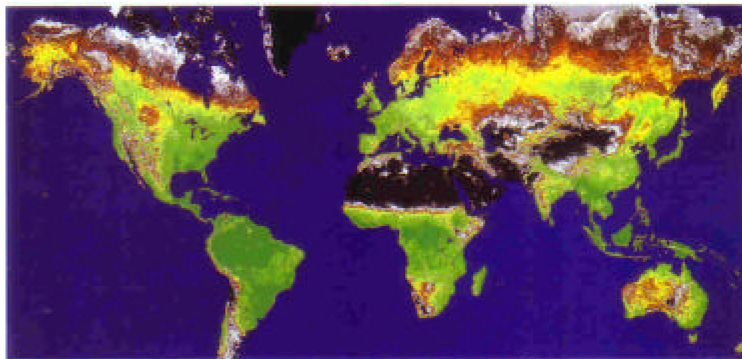
For those just starting to look into insurance for multinational merger & acquisition processes, Michael Rossi suggests that you should first distinguish between the label and the actual function of products

Insurance products specifically designed for use in the context of a merger, acquisition or similar corporate transaction have been used in the UK for about twenty years. but their use has increased dramatically in other parts of the world.

Looking at this issue from an international perspective, the difference depends upon whether you're working in the US or the UK. Yet, even within the US and UK, the same products are referred to by different names.

Accordingly, when thinking of M&A insurance, one should focus on the type of risk and function intended to be served by a particular product, rather than the 'label' given to it. The type of risk at issue typically falls within one of 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 thus require a long list of representations and warranties (R's & W's) from the seller; who provides the state of affairs of the business or assets that are being sold.



Such R's & W's can touch on everything from accounts receivables, to tax treatments, to pollution conditions, and pension issues, etc. All issues pertaining to the business 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 R's & W's by the seller prove to be wrong, either through fraud or an innocent mistake? That is a risk inherent in all M&A and related corporate transaction activity. M&A insurance can address such risks, by insuring the buyer or seller with respect to losses flowing from a breach of a representation or warranty.

What if the risks are actually known, but not yet quantified? For example, 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 mayor may not come to fruition?

When thinking of M&A insurance, one should focus on the type of risk intended to be covered...rather than the 'label' given to a particular product

Such a risk can come in various forms. For example, if the deal is premised on the assumption that a large proportion 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 obliged to renew the contracts. There is a risk that if a large enough proportion of the customers do not renew their contracts after the deal closes, 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 there is a risk that tax authorities will disagree with the treatment, thus 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 it. The 'certain' number is the self-insured retention and the premium to pay for the insurance. With such certainty, the parties to the transaction can determine if the deal makes sens e or not to go forward.

With a few exceptions, M&A insurance products fall within one of the two categories identified above. That said, various names used for the products to insure one or all of the risks described above include:

* Warranty and Indemnity Insurance name used mainly outside of the US referring to 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 – 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 – name used mainly in the US to insure known but not yet quantified risks
* Tax Indemnity Insurance – aka Tax Opinion Insurance – name used mainly in the US to insure known but not yet quantified tax risks
* 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
* Clean-up 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 clean-up obligations.

Another issue is the differences between, as well as the reasons for using either a purchaser's policy or vendor's policy.

The proponents of the purchaser's form believe that a vendor's form involves the 'moral hazard' of insuring someone for his or her own fraud or faulty due diligence.

The proponents of the vendor's form believe that M&A insurance works best when it is in the form of liability insurance (as in a vendor's form), as opposed to first-party insurance or hybrid first-party/liability insurance (in the case of a purchaser's form).

Since two different products exist, there are usually two different ways to use M&A insurance, and thus two different ways to structure aspects of any deal.

On the one hand, you have the vendor retain the risk, but have the indemnity agreement with purchaser provide that the vendor's liability to the purchaser for breach of a representation or warranty is limited to breaches covered by the M&A insurance.

Conversely, you have the vendor's liability for breach of R or W capped, or otherwise limited, below what the purchaser needs for protection for the deal to go through; and use a purchaser's form to give the purchaser that added layer of protection.

In summary, if you wish to play any role in merger, acquisition and related transaction activity for your company, or your clients, you should make every effort to understand the different types of M&A insurance products that are being used with greater frequency in the UK, Europe, Australia, US and elsewhere.

One must understand that...there are usually two different ways to use M&A insurance -and thus two different ways to structure aspects of any deal

Michael A. Rossi is President of Insurance Law Group, Inc.