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RISKY BUSINESS

DESPITE IMPROVEMENTS IN M&A INSURANCE, MANY DEALS STILL CLOSE WITHOUT COVERAGE, LEAVING BOTH BUYERS AND SELLERS OPEN TO RISK

BY JOHN MCNALLY

2010 WAS A RECORD YEAR for the placement of M&A insurance, with an estimated 50% more transactions deploying safeguards than in 2009. Yet many private equity deals still close without any form of insurance advice—let alone a policy. In the latter case, deal participants face a major risk that the value of an investment or transaction could be materially impacted, or even destroyed.

Following the global financial crisis, we are seeing a more cautious M&A market, with deal participants notably risk averse and concerned about execution issues. Buyers are more concerned about the strength of sellers' financial covenants. Banks providing financing are looking to manage their exposures. Private equity sellers are looking to make a clean exit from transactions. Management sellers, who are giving warranties, seek the ability to protect against a potential liability arising out of an unforeseen breach.

IN THE PAST, DEALS WERE SOMETIMES DELAYED BY THE INSURANCE PROCESS.

In each of these cases, we are seeing the different deal participants turning to M&A insurance to help manage these exposures. However, M&A insurance is no longer just about risk transfer. Buyers and sellers are using insurance policies as a strategic tool in their negotiations to maximize the efficiency of capital structures. M&A policies are becoming a very effective strategy to differentiate bids, minimize escrows and indemnities, or provide extra security on transactions.

The risks are still very real, as evidenced by what we are seeing in claims. Looking at insured warranties historically, some two-thirds of claims arose during the first 12 months post-completion—including during the 100-day review and first audit cycle of the acquired business. On U.S. insured transactions since 2000, approximately 20% of policies written were put on notice of claims. For insured international transactions, between 10% and 15% of policies written since 2000 were put on notice of claims.

The most frequent types of insured claims we see arise, in order, from inaccuracies or misrepresentations in the financial accounts warranties, tax warranties and compliance warranties, followed by deal-specific matters such as intellectual property infringement in technology deals or environmental claims on industrial businesses.

Claims arising under tax warranties have included underpayment of income or corporate tax, transfer pricing tax methodology and value-added tax or sales tax. Known tax issues may also be insured, for example when a deal is done based on the expectation that the tax will be treated one way—but the tax authorities investigate and assess based on a different interpretation of case law or legislation. The result may be an unexpectedly large tax bill for buyer or seller.

Breaches of compliance with law warranties are seen most frequently in regulated sectors such as financial institutions, pharmaceutical businesses and healthcare.

To keep up with the changing risk environment and needs of the deal community, the insurance market has improved its level of sophistication and responsiveness. The policies and the underwriting process involved now more closely match the requirements of the buyers and sellers. Insurers are delivering better execution, with broader coverage, timing and flexibility required in the deal environment.

M&A insurance policies are now clearer and easier to understand. There are fewer standard exclusions, the common ones being forward-looking warranties; warranty breaches known at signing; uninsurable fines and penalties; and fraud or fraudulent misrepresentation by the insured (although seller's fraud may be covered on a buyer's insurance policy).

Insurers are also more open to negotiating policy terms and conditions to ensure that they match the underlying indemnification structure and substance of warranties in the sale and purchase (or merger) agreement. Insurers are also underwriting a wider range of risk structures—including distressed sales and secondary private equity deals, where there is limited recourse against the sellers—and also sectors such as healthcare, energy and financial institutions.

In the past, M&A deals were sometimes delayed by the insurance process. With a more sophisticated approach, insurers are doing a better job of completing their due diligence and writing insurance policies within the time frame of the overall deal negotiations.

M&A insurance has changed significantly over the past five years. Despite these market developments, many deals still close without insurance advice or coverage. Those buyers and sellers leave themselves open to risk or, at the very least, are not looking at all the tools that are available to help them improve their financial position, whether buying or selling a business. ■

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