



MINTZ

# Leveraging Transactional Insurance to Win the Bid in Mergers & Acquisitions

ACC National Capital Region In-House Summit

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# PRESENTERS



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# AGENDA

- Representation & Warranty Insurance
- Other Transactional Liability Insurance Products
- Standing Out in the Auction Process
- Success Strategies for the Underwriting Process

# **Representation & Warranty Insurance**



# What is Representations & Warranties Insurance?

- Representations and warranties insurance (“R&W Insurance”) is an **insurance product** that provides coverage for **losses** incurred as a result of **breaches of the representations and warranties** made in transaction agreements.
  - Typically used by the Buyer to insure losses it has incurred as a result of breaches of representations and warranties made by the Seller in an acquisition agreement
  - All types of transactions: Stock deals, mergers, asset acquisitions and minority investments
- Separate policy from the target’s existing policies

# The Current Market and Participants

- A Robust Market:
  - \$46 billion of total limit issued in 2018
  - Private equity firms use R&W Insurance more frequently but strategics are catching up
- More than two dozen insurers
- Deal Size ranging from ~\$10 million to several billion
- The competitive marketplace has led to better policy pricing and terms
- Sophisticated brokers dedicated to the R&W Insurance product, who play active roles in the selection of the insurer and the negotiation of the policy
- Legal counsel with experience representing both the insureds and the insurers, who advise insureds on every aspect of the R&W Insurance process

# Benefits of R&W Insurance

## Why Buyers Like The Product

- Increase amount and/or duration of indemnity coverage
- Distinguish Bid in an Auction
- Mitigate Collection Concerns
- Protect Key Relationships
- Protect the Deal
- Assure Purchase Price

## Why Sellers Like the Product

- Increase Proceeds at Closing
- Protect Passive Sellers
- Expedite Sale Process
- Reduce Contingent Liabilities

# How RWI Helps Facilitate a Deal

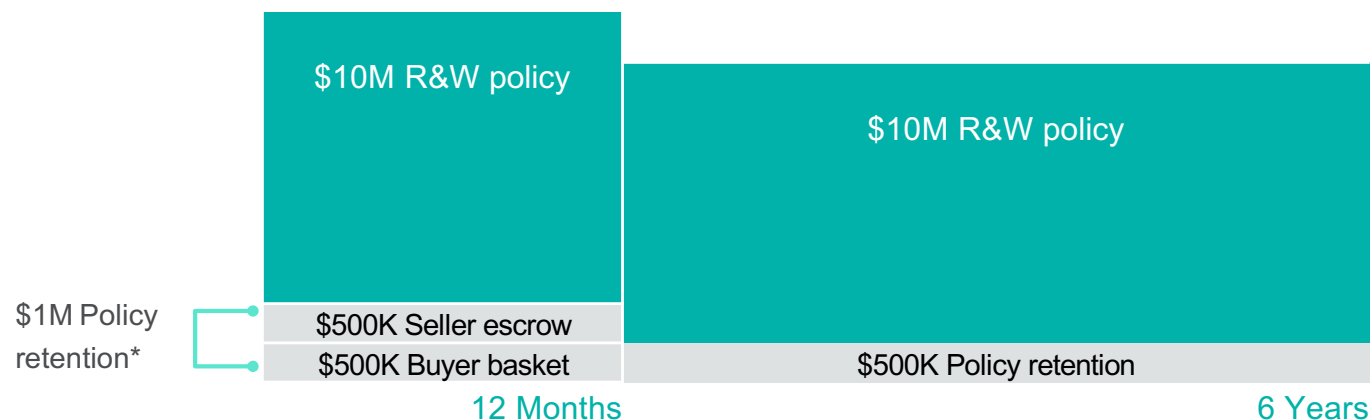
- A buy-side R&W policy can enhance or replace seller indemnification under the purchase agreement.

	Typical indemnification coverage	Typical policy coverage
<b>Survival or policy period</b>	<ul style="list-style-type: none"> <li>▪ 12-18 months for general reps.</li> <li>▪ SOL for fundamental reps.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Three years for general reps</li> <li>▪ Six years for tax and fundamental reps.</li> </ul>
<b>Indemnification cap or policy limit</b>	<ul style="list-style-type: none"> <li>▪ 10-20% of purchase price for general reps.</li> <li>▪ Seller escrow of such amount typically required.</li> </ul>	<ul style="list-style-type: none"> <li>▪ 10-20% of purchase price is typical (but may be able to insure up to 100%)</li> <li>▪ Seller only needs to escrow 0-1% of proceeds.</li> </ul>
<b>Loss definition</b>	Inclusion of consequential damages, DIV, multiplied damages, and similar damages is heavily negotiated.	Insurers are willing to follow silence with silence, as long as purchase agreement does not explicitly grant/exclude such damages.
<b>Materiality scrape</b>	Inclusion of single or double scrape and materiality qualifiers in reps is heavily negotiated.	Policy will follow scrape agreed to in purchase agreement (and buyer typically can get a synthetic scrape in NSI deals).
<b>Recourse for breaches</b>	Buyer's recourse is to proceed against the escrow, which may include proceeds owed to management/rollover sellers.	After retention is satisfied, the policy will respond to all covered matters. Buyer has right (but not obligation) to proceed against the escrow to satisfy part of the retention.



# RWI: Buy-Side Policy Structure Example

Transaction value	\$100M
Escrow	\$10M – reduced to \$500K due to policy
Buyer basket	\$500K
Policy placement	Buy-side R&W policy covering general reps for three years and fundamental/tax reps for six years
Policy limit	\$10M
Policy retention	\$1M first 12 months, then \$500K
Premium	\$300K (3% of limit)



## Benefits of a buy-side policy

Buy-side policies replace most or all of seller indemnification and insure the buyer for a longer period of time whereas sell-side policies are solely to backstop seller indemnification and reimburse the seller for indemnification claims paid to the buyer.

\*Retention is eroded by (i) losses incurred pursuant buyer basket; and (ii) amounts recovered from seller escrow. The retention drops down after the seller escrow is released.

# What Does R&W Insurance Cost?

- Underwriting Fees
  - One-time charge at the beginning of the underwriting process
  - Covers the cost of the insurer's outside counsel
- Premiums
  - Calculated using a "Rate on Line", which varies depending on coverage limits and whether the Seller has "skin in the game"
- Broker Fees
  - Paid as a portion of the premium (usually 15% but negotiated between insurer and the broker)
  - Some brokers are adding a separate additional fee in addition to commission
- Taxes
  - Premiums are taxable in the state of domicile of the buyer (surplus lines tax of 3% to 7.5%)
  - Loss proceeds are taxable, so consider buying "gross up" coverage for tax payments

# Standard Terms

- Coverage Limits
  - Insureds typically purchase coverage at least 10% of the TEV
  - Flexibility to increase the coverage limits, all the way up to 100% of TEV
- Retentions
  - The amount that the insured must clear before submitting a claim
  - Typically 1% though can be higher on deals under \$50M or lower on deals greater than \$250M
  - The retention will “drop down” to half of the original amount after 12-18 months.
- Survival
  - General representations = 3 years
  - Fundamental representations = 6 years
  - Longer survival periods can be purchased for additional premium
- Subrogation
  - In the event of a claim, insurers will not turn around and seek recovery from the Seller, other than in the case of fraud.

# Covered Losses

- R&W Insurance policies cover:
  - Losses resulting from a breach of any of the representations and warranties made by the Sellers and Company in the definitive acquisition agreement that are unknown at the time of Closing; subject to exclusions
  - Pre-Closing tax indemnity (excluding accrued taxes that are not yet payable)
- Coverage is also available for:
  - Representations and warranties in ancillary documents, including Letters of Transmittal
  - Certain interim breaches
  - Certain insurers will distinguish themselves by industry focus, writing policies covering industry specific losses, like Healthcare.
- They do not cover losses associated with:
  - Interim breaches, though pre-COVID there was a push to expand this coverage
  - Covenants
  - Special indemnities (other than the pre-closing tax indemnity)
  - Purchase price adjustments
  - Exclusions: Standard and Deal Specific
  - Consequential damages

# Exclusions

- Most R&W policies contain a standard suite of exclusions to the coverage
  - Asbestos/Silica
  - Transfer pricing matters
  - Amount and availability of NOLs
  - Unfunded or under funded defined benefit plans
  - “Disclosure”
  - “Buyer Knowledge”
  - COVID
- Brokers are putting pressure on insurers to remove many of these standard exclusions, so we are seeing some variance among underwriters.
- Other Insurance
  - Whether as an exclusion or “other insurance” provision, insurers expect the target’s insurance program to respond first or exclusively (i.e., medical malpractice, cyber liability, product liability, etc.)

# Exclusions - Deal Specific

- Depending on the target and the results of the underwriter's diligence, the insurer may also include deal specific exclusions:
  - Pre-Closing restructuring (i.e., F-Reorgs, pre-Closing charter amendments to affect modifications of the funds flow, etc.), typically limited to tax exposures resulting from the restructuring
  - Data Privacy (GDPR in particular)
  - Local law compliance
    - Underwriters will look to the materiality of the international operations
      - If de minimis, they will likely take the risk
      - If material, expect exclusions if insufficient diligence
    - US state and municipal issues if insufficiently diligenced
  - Sales and use tax liability
  - Reimbursement
  - 409A
  - FLSA and Wage & Hour exposures

# Other Transactional Liability Insurance Products

# Other Transaction Liability Insurance

R&W Insurance covers only unknown issues. For specific indemnities for known issues, other transactional insurance products are available:

## Unknown risks

**1. Representations and warranties insurance** (RWI) indemnifies a party to a transaction for financial losses arising out of:

- Breaches of a representation or warranty
- The pre-closing tax indemnity

## Known risks

**1. Tax insurance** indemnifies the insured for taxes, interest, penalties, contest costs, and gross-up (loss) arising out of a specific and known issues, such as:

- S-corp status
- Federal energy (ITC) tax credits
- REIT status
- Tax-free status of a restructuring

**2. Contingent liability insurance** indemnifies the insured for losses arising from certain contingent liabilities such as:

- Successor liability
- Fraudulent transfer/conveyance
- Existing litigation



# Tax Insurance

- Tax insurance provides coverage for taxes, interest, penalties, contest costs, and gross-up (loss) arising out of a specific and known tax issue. It can:
  - Cover the outcome of a tax opinion.
  - Cover a tax issue for which an opinion has not been obtained.
  - Replace or backstop an indemnity in a transaction agreement for a specific tax risk.
  - Allow for removal of a balance sheet reserve for a tax issue.
- The one-time premium for a 6–7 year policy ranges from 2–8% (depending on the facts and circumstances related to the tax risk in question). Retentions are generally only applicable to the contest costs portion of loss.

## Federal energy (ITC) tax credits

- Risk that investment structure will be disallowed.
- Risk that inside basis will be adjusted.
- Risk of recapture.

## REIT (tax status/ real estate reps)

- Covers REIT status.  
Most commonly covered via coverage for reps in the purchase agreement relating to validity of REIT status

## M&A tax concerns

- S corp status and Section 338 election (step-up in basis).
- Ability to claim and use tax attributes (NOLs, tax credit carry-forwards, step-up in basis, etc.).
- Uncertain tax positions taken in prior years.

## Other tax concerns

- Tax-free spin-offs.
- Deferred and executive compensation.
- Restructurings, recapitalizations, and re-financings.

# Contingency Insurance

- Contingent Liability Insurance indemnifies the insured for financial losses arising from various contingent liabilities such as:
  - an existing piece of litigation
  - successor liability and fraudulent transfer/conveyance risks
- In order to consider a risk, the key facts underlying, and legal arguments supporting, the contingent risk must be ascertainable and made available to the carrier.
- In an M&A context, can be used to release or backstop a seller escrow and ring-fence potential damages from an adverse judgement. Outside of an M&A context, can be used to allow for the release of a balance sheet reserve or alleviating concerns of a lender or investor.
- The one-time premium for a 6–7 year policy ranges from 3-4% rate for successor liability/fraudulent transfer risks and 10-20% rate for litigation risks. Retentions are generally only applicable to the contest costs portion of loss.

# **Standing Out in the Auction Process**

# Standing Out in Competitive Processes

- Buyers can distinguish themselves in competitive processes by leveraging R&W Insurance and other transactional liability insurance products.
- Process Letter/Messaging
  - Signal to the Seller from the beginning that you are willing to consider using R&W Insurance
  - Establish your experience with the product (and that of your deal team)
  - Consider shouldering insurance fees or splitting between Seller and Buyer
- Engage your third party advisors early (legal memos, IT diligence, tax reports, QofE, etc.)
  - Underwriters will need to see those reports to complete their process.
- Consider pre-exclusivity underwriting
  - Not very common and expensive, but can allow you to closing very quickly

# Standing Out in Competitive Processes...cont'd

- Markup bid-draft contemplating R&W Insurance
  - Push for aggressive buyer-friendly representations and pre-closing tax indemnities. On indemnification, unlimited potential scenarios, but commonly:
    - 12 month survival for general reps, SOL for fundamentals (don't try to stuff fundamentals)
    - Split the retention (0.5% deductible with a 0.5% Seller escrow). CAREFUL – don't cannibalize the indemnity escrow for working capital adjustments.
    - Buyer-friendly knowledge definition
    - Double materiality scrape
  - Use insurance to solve negotiation roadblocks
    - If Seller resists making a representation fundamental (e.g. IP), consider offering to buy an excess layer of coverage for IP representations and have Seller pay the additional premium.
    - Allocate risks from special indemnities using other transactional liability insurance products.

# Success Strategies for the Underwriting Process

# Engage your Broker & Insurance Counsel Early

## Broker

### Initial advice

Review information. Initial advice on coverage and insurers. Submit information to chosen insurers for nonbinding terms.

### Advise on initial terms

Advise on initial terms and preferred insurer(s).

### Negotiate coverage and underwriting

Negotiate coverage/policy. Facilitate flow of information. Advise insured on policy terms and any transaction-specific exclusions.

### Instruct insurer to bind coverage

## Insured/deal team

### Information provided

Purchase agreement. Target financials. Information memorandum.

### Choice of insurer(s)

Choose insurer(s) with benefit of Lockton's advice on terms received and other factors.

### Provision of information

Provide information (data room, DD reports). Discuss terms of coverage with Lockton. Participate in underwriting call.

### Instruct Lockton to bind coverage

Provide no claims declaration.

Day 1

Day 3

Days 4–10

Day 10

Execution of  
transaction agreement

# Negotiating the Policy and Due Diligence

- Once a Buyer has won exclusivity and an underwriter has been chosen, the underwriter will begin their underwriting diligence:
  - Scope: Review of the Buyer's Diligence
    - Hire outside counsel to review due diligence reports and definitive agreement (note: carriers will sign Non-Reliance & Common Interest Letter prior to delivery of any third party memos)
    - Spot check data room
- Insurers will seek to confirm:
  - The purchase agreement is drafted as a reasonable arms length agreement (i.e., R&W are not too Buyer friendly)
  - Seller is reasonably disclosing against the reps
  - Buyer is conducting thorough diligence taking into account the target's operations
- Insurer diligence can be complicated by:
  - Unaudited financial statements (QofE likely required)
  - Industry specific concerns (i.e., healthcare regulatory risk)
  - Extensive foreign operations



# Tailoring your Due Diligence Process

- The underwriting process, driven largely by financial buyers, was originally designed around a Buyer that relies exclusively on third-party advisors for diligence support (legal, accounting, environmental, IT, etc.).
  - Typically these advisors produce reports summarizing all material concerns.
- BUT, as more strategic buyers began to use the product, insurers have evolved their processes to account for internal diligence teams and fewer third party reports.
- At the same time, many strategic buyers are tailoring their diligence process to better align with the needs of underwriters:
  - Diligence Trackers
  - Internal Reports
  - Scope of diligence

## Tailoring your Due Diligence Process...cont'd

- Carriers will work with large strategic buyers to learn their diligence processes and develop relationships that allow for smoother underwriting.
- While third party diligence memos are preferred, internal diligence is acceptable noting the following:
  - If the target has unaudited financials, a third party QofE will be required from a reputable accounting firm.
  - It must be undertaken by subject matter experts and include standard diligence streams including legal (covering corporate matters, material contracts, real property, litigation, regulatory, labor, benefits, intellectual property), financial, tax, insurance, and the following as applicable: environmental, technology and data security, billing and coding.
  - To the extent there are any foreign operations, diligence by local advisors is required.
  - The diligence review must be memorialized in a form that can be provided to carriers including a summary of the scope of review and key findings.

# Insurer Underwriting Calls – Be Prepared!

- The underwriting call is held within a day or two of the carrier receiving draft disclosure schedules, data room access, and drafts of all diligence memos.
- Insurer and their counsel use the call as their primary opportunity to obtain additional color on the deal negotiations and diligence process based on what they've seen in the diligence memos, schedules and data room issues.
- Process:
  - On average the call is 1.5-2 hours long.
  - The lead business team, and applicable legal specialists are expected to participate.
  - Every insurer has a slightly different approach to the call, but they will typically circulate an agenda (or list of questions) in advance of the call with varying levels of detail.
- Preparation for underwriting call is critical.

# Post Due Diligence – Keep the Broker Informed

- Additional Underwriting Items
  - Follow up questions from the underwriting call
  - Ongoing process with the Insurer until it has signed off
- Negotiation of the Policy (Parallel Track)
  - Typical Negotiation Items
    - Exclusions
    - Binding: Signing vs. Closing
    - Defined terms (actual knowledge, breach, loss, etc.)
- Continue to Turn Corporate Documents
  - Always update the broker with new turns of the purchase agreement and schedules
- Bring Down Call if a delayed sign and close

# No Claims Declaration – Avoid Insurance Fraud!

- At Inception, the Insured will submit an “Inception No Claims Declaration”, certifying that:
  - The Deal Team Members have read all of the Transaction Documents and due diligence reports.
  - No Deal Team Member has Actual Knowledge of any Breach.
  - The Insurer has been provided with true and complete copies of “the Acquisition Agreement and any formal, final (or to the extent not final, the most current draft) written due diligence reports prepared by the Insureds and/or their advisors in connection with the transactions contemplated by the Acquisition Agreement.”
- If a delayed sign and close, the Insurer will ask for a NCD at both signing and closing, to establish that no interim period breaches are known.
- If there is significant rollover (i.e., 40% plus) the Insurer may ask for the Seller to sign a NCD as well, to establish that the Seller is not aware of any breaches.

The background of the slide is composed of various overlapping triangles in different shades of teal, blue, and green. The colors range from dark, muted blues to lighter, brighter greens, creating a complex, layered geometric pattern.

**Questions?**

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- Serves as lead M&A counsel at Willis Towers Watson
- Has in-depth experience as in-house counsel leading and coordinating the legal aspects of domestic and international M&A and antitrust activities at large global companies
- Works with cross-functional teams to partner in transactions such as M&A, divestitures, equity investments, joint ventures, teaming, IP collaborations and strategic alliances
- Previously served as Managing Executive of the Division of Investment Management at the Securities and Exchange Commission

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- Represents financial sponsor and strategic buy clients in the procurement of Representations & Warranties, Tax Liability, and Contingent Liability Insurance Policies
- Joined Lockton's Transaction Liability Group in March 2014 after nine years as an underwriter at Ambridge Partners
- Received a B.A. in Psychology and a MBA in Global Business, both from the Clark University





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- Leads Ambridge's North American R&W practice managing a team of underwriters in New York
- Joined Ambridge, a specialized managing general underwriter of complex risks, including transactional, tax and intellectual property insurance, in 2006
- Nearly 14 years of experience as an underwriter of transactional insurance products
- Received a J.D. from the University of Notre Dame Law School and a B.B.A. from the University of Georgia



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MINTZ

- Focuses practice on helping clients solve the increasingly complex and sophisticated challenges of corporate transactions
- Serves as a strategic counselor to clients, working with them to structure, negotiate, and execute various transactional arrangements, with a particular focus on private company mergers and acquisitions, growth equity investments and joint ventures
- Clients span a broad range of corporate organizations, including well-known private equity sponsors (funds and family offices), large multi-national corporations, and both early-stage and late-stage grown companies
- Co-leads Mintz' Transaction Liability Insurance working group