Trends and Features of Transactional Liability Insurance and its Effects on the M&A Marketplace

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Peter Rosen
Drew Levin
Latham & Watkins LLP

Gary Blitz
Jill Kerxton
Aon Transaction Solutions

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I. What is Transactional Liability Insurance?

A. Representation and Warranties Insurance Policies

Transactional liability insurance has arisen in recent years as a solution for many types of transactions in the mergers and acquisitions marketplace. Historically, after performing its due diligence and assessing relevant risks, a buyer in an M&A transaction might push for broader indemnification or a larger escrow (e.g., 10% of purchase price) as collateral against potential breaches of seller's or the target's representations and warranties. In certain circumstances, a buyer might even push for other post-closing mechanisms, such as holdbacks or earn-outs, effectively further reducing the purchase price. More recently, however, with the popularization and use of the representation and warranty insurance product, buyers can achieve a sense of comfort that, upon completion of a reasonable diligence process, recourse with respect to representations and warranties can be assured. This ultimately can result in greater certainty for the buyer and a better economic deal for the seller, which is permitted to exit the sale leaving behind less in escrow. In this way, representation and warranty insurance ("RWI") can be beneficial for both a buyer and a seller in an M&A transaction in that it can provide greater post-closing certainty for each party by providing an alternative path for risk assumption with respect to a transaction agreement's representations and warranties.

At a basic level, representation and warranty insurance protects a buyer against loss from unknown breaches of the representations and warranties of either a target company or its selling equity holders that are discovered post-closing (or even post-signing, if structured accordingly). Policies can also be obtained by sellers as a backstop against a seller's indemnification obligations post-closing (although these "seller-side" policies are far less common). Representation and warranty insurance policies can expedite the progress of a deal, create additional bid certainty in auction contexts, minimize escrow obligations or indemnification caps, extend the survival of buyer's right to indemnification, facilitate a clean exit and earlier distribution for sellers, and minimize buyer's risk with respect to seller's creditworthiness.

Insurers offering RWI will perform their own underwriting which will include a review of the data room, review of diligence reports prepared by a buyer and its representatives (shared on a non-reliance basis), and a diligence call and other discussions with buyer and its representatives. Insurers in the market today have the capacity to insure limits ranging from $1 million to over $1 billion. Typical policies, like contractual indemnity caps, have limits of liability set at 10% or 20% of enterprise value. In some cases, parties may insure a larger percentage of the enterprise value of the transaction or buy additional limits to protect specific representations, such as certain fundamental representations involving title, corporate formalities or intellectual property in the context of the sale of a technology company.

Policies typically extend six years from closing for breaches of fundamental and tax representations, with a three-year term for other representations. These term lengths are typical regardless of the length of survival of the representations and warranties in the underlying transaction documents. This means that a typical RWI policy can potentially provide an extension of coverage for a buyer under the seller's and target's representations. Most policies are subject to a retention (i.e. deductible) that typically ranges from 0.75% to 2% of total

transaction value, which tends to be shared equally between the buyer and seller. However, when the underlying transaction is structured as a public style or no seller indemnity transaction, the retention will be borne entirely by the buyer, and the premium may be slightly increased, usually by about five percent. Policies can be structured such that the retention (or deductible), if there is one, is reduced as an escrow fund is released (typically at 12 or 18 months), and a policy will generally match the structure of the underlying deal with respect to both the materiality scrape and pre-closing tax indemnity.

Certain items, however, that may receive coverage by the representations and warranties of an underlying deal, may not be covered by a RWI policy, including: (i) known or scheduled matters, (ii) known breaches (which may be addressed via a separate contingency policy), (iii) deferred tax assets, and (iv) certain tax issues, such as net operating loss carryforwards and transfer pricing, and (v) underfunded benefit plans. Likewise, after performing diligence, an insurer may propose additional, deal-specific exclusions based on concerns arising from its own underwriting.

B. Tax Indemnification Policies

Separate tax indemnity policies may also be available to protect the insured against an adverse ruling by the Internal Revenue Service ("IRS") or other relevant taxing authority with respect to certain manifest tax risks, including the anticipated tax treatment of the underlying transaction or a given diligence issue relating thereto. Such policies can cover tax, interest, penalties, contest costs and gross-up for tax on the insurance proceeds.

A tax indemnity policy can be used to improve the odds of execution by bridging the gap between a buyer's evaluation of a particular tax issue and the seller's evaluation of the same issue. These policies do not necessarily require that a formal tax opinion be obtained, though providing insurers with some work product to underwrite can make for a more efficient underwriting process. Such policies can cover potential issues relating to S Corp. qualification and section 338(h)(10) elections, reorganizations (either that they are tax free or not more taxable than intended by the parties), tax-free spinoffs, net operating losses, section 335(e), transfer pricing, the sale of REIT shares, real estate issues or cross-border issues.

II. History of Transactional Liability Insurance

Transactional liability insurance has existed as a potential transaction solution since the early 1980's, when Lloyd's of London first provided tax insurance for leasing transactions. The RWI product emerged on the scene in the late 1990's. Like many products, the earliest versions were too limited in coverage and the process was too costly and time-intensive to be of much use in the marketplace.[1] Today, however, the product has matured and the process has been dramatically streamlined, and the result has been the use of transactional liability insurance truly burgeoning, with over 1,000 policies underwritten in the U.S. in 2016 and approximately 2,250 worldwide. From total policy limits of under $5 billion in the U.S. in 2012, current estimates show a total of over $25 billion in limits in the U.S. for such policies in 2016 – more than a five-fold increase.

[1] https://irmka.scic.com/2015/06/04/transactional-liability-insurance/

A key catalyst for the change has been a shift in insurers' views on the diligence process. Originally, insurers would typically undertake a lengthy and independent diligence review of the target company with respect to the representations and warranties to be covered by a given policy. This process could take months in total and the engagement of multiple insurers (to see which would ultimately provide acceptable terms) and was typically intrusive to the in-process transaction. In recent years, however, insurers have become more comfortable relying upon the diligence performed by a buyer – such that the insurer's process focuses on conducting secondary diligence of the buyer's primary diligence. This approach greatly reduces both the intrusiveness of and time required by the underwriting process, making it a much more attractive solution for both buyers and sellers.[2] Additionally, insurers now staff their underwriting teams with former M&A attorneys who are familiar with applicable deal mechanics and timeframes, which enables greater customization of policies and streamlining of the underwriting process for a given transaction. Insurer initial indications of interest are typically available within days. New insurers are continuing to enter the field, increasing competitiveness and overall capacity. From fewer than ten insurers just four years ago, there are now nearly thirty insurers in the marketplace.

III. **Current Statistics and Trends**

As discussed above, the volume of deals utilizing transactional liability insurance has been steadily on the rise in recent years. In North America, Aon Transaction Solutions alone has seen its total policy limits rise from approximately $2.1 billion in 2013, comprising 54 total policies, to $[●] 15 billion in 2017, comprising [●] 460 policies.

A. Analysis of Cost Considerations

Which party pays for a RWI policy is negotiable and, where a seller demands that buyer cover the cost, can be considered in connection with the total purchase price being offered. A typical RWI policy would carry a total cost of around 2.75-3.5% of the total insured limit under the policy, although this rate will be somewhat dependent upon the specific details of the transaction; for instance, deals without any seller indemnification provision would typically lead to a slightly higher premium for any applicable RWI policy. Rates are also dependent on the scope of coverage being secured, with significantly lower rates (for more limited coverage) generally available for non-U.S.-style transactions.

In terms of retentions (which are also referred to as deductibles) under the policy, 0.75-2% of total transaction value is typical. Recent competition among insurers is driving this figure down; similarly, for certain simple operations, such as a privately held REIT, insurers may only require even lower retentions. Retentions may be slightly higher (or, on the higher end of the 0.75-2% range) in a no-seller-indemnity structure. For practical purposes, the retention under a buyer-side RWI policy will often match the sum of the deductible and escrow in the underlying agreement. Relatedly, as noted above, the policy retention may drop down upon the release of the escrow funds.

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[2] *Id.*

B. Key Coverage Differentiators and Advantages of Utilizing RWI Policies

Key differentiators of RWI policies, as compared with standard indemnification and related provisions of a transaction agreement, include:

- *Increased policy duration* – RWI policy terms will typically exceed those for the survival of the representations and warranties of an underlying deal;
- *Coverage limits* – Insureds may purchase coverage of up to 100% of the purchase price, as opposed to a typical seller indemnity coverage of 5-10% of the purchase price;
- *Definition of Loss* – Carriers will generally only exclude categories of loss where they are excluded by an underlying agreement (i.e., "follow silence with silence"), which leaves the door open for potential recovery of consequential and multiplied damages;
- *Materiality Scrape* – Carriers will generally recognize the materiality scrape of an underlying agreement, and disregard applicable materiality qualifiers in a seller's or target's representations and warranties when determining the existence of a breach and/or calculating damages, as applicable.

Buyers and sellers may each have strong motivations for introducing RWI as an element of a transaction. In addition to the factors outlined above, buyers can use RWI in an auction process in order to distinguish their bid from other prospective purchasers, to protect key relationships in the context of a proposed management rollover, ease collection concerns (particularly from a distressed or otherwise uncreditworthy seller), or provide recourse where no seller indemnity would otherwise be possible. Sellers, on the other hand, can look to an RWI policy to reduce or eliminate post-closing indemnity obligations for unknown breaches (thus adding deal certainty), thereby reducing contingent liability, protecting passive sellers, aiding in the timely distribution of sale proceeds, expediting a sale process, and, during the sale process, attracting the best offers from prospective buyers by enhancing recourse options for those buyers.

IV. How Transactional Liability Insurance Shapes M&A Transactions

In the current marketplace, the availability and use of transactional insurance can often shape the form and process of the underlying transaction. Some examples from our experience, showing the operation of this influence, follow below.

A. Example A – RWI Policy to Reduce Purchase Price

A U.S. private equity fund was purchasing a manufacturer for approximately $1 billion, with a $100 million escrow/indemnity cap. The fund was approached with a proposal to replace a portion of the escrow/indemnity cap with a buyer-side RWI policy, in the hope that the fund would then be able to obtain a purchase price adjustment in the fund's favor.

A buyer-side RWI policy for $80 million excess of a $20 million deductible was negotiated and placed, which provided coverage broader than the seller indemnity. Additionally, the policy period extended for the standard six years for all fundamental and tax representations and warranties, and the retention would be reduced to $4 million after 18 months in conjunction

with the release of the escrow. In connection therewith, the fund was able to negotiate an ultimate purchase price of $975 million – about $22 million less than initially contemplated (after taking into account the insurance cost).

B. Example B – "Stapled Insurance Package" to Minimize Escrow and Indemnity

A U.S. private equity firm was preparing to sell a $400 million manufacturing company through an auction process. The target company was the last of 15 divestitures from a holding company, and therefor had numerous hanging indemnities from past sales, plus potential tax and environmental issues. The seller hoped to effect the sale on an "as is" basis, in order to have no surviving indemnities or escrow post-closing.

Before commencing the auction, quotes were structured and obtained for a package of representations and warranties, tax and environmental insurance in favor of an eventual purchaser. Prospective purchasers were directed to work with Aon, and the private equity firm made it known that it would provide no indemnities. Ultimately, the RWI policy was able to cover the hanging liabilities from the holding company's prior transactions in addition to the representations relating to the target transaction, and the transaction agreement had no survival period and provided a credit against the purchase price for the insurance cost (which amounted to 1% of transaction value). Through this approach, the seller was able to encourage more bids and a better ultimate sale price than it had anticipated. Additionally, because the prospective insurers had already vetted the applicable risks, buyer's due diligence process was generally smooth and straightforward, which helped contribute to a successful auction process.

C. Example C – RWI Policy to Ease Collection Concerns

A publicly-traded company in the manufacturing industry had purchased the diesel engine business of another publicly-traded manufacturing company for approximately $150 million. The parties negotiated a $3 million escrow and a $20 million cap on indemnification for breaches of representations and warranties, but the buyer was concerned about its ability to collect under the indemnification provisions of the agreement because the seller was in danger of becoming insolvent at the time of the sale.

To resolve these issues, an RWI policy for the buyers was structured and negotiated that provided a primary recourse to the buyer above the amount of the escrow. The policy had a $20 million limit and a $3 million retention (which was equal to the escrow). The parties further were able to amend the purchase agreement in order to provide that the seller would only have liability in the amount above the escrow in the event that the policy did not provide coverage, and in return the seller agreed to pay 50% of the policy's premium.

D. Example D – Cross Border Tax Insurance

A non-U.S. company sought to purchase the shares of a U.S. manufacturing corporation from a private equity seller. The buyer's due diligence revealed that a prior restructuring transaction might be taxable under complex consolidated return regulations. This was unexpected, because the private equity firm had received a legal opinion that the transaction

should be tax-free. This opinion, however, was based on several assumptions about events that did not ultimately occur. The private equity firm refused to provide the buyer with full tax indemnity. The buyer had 10 days remaining in its period of exclusivity with the target (which included the Christmas holiday), and the private equity firm was unwilling to extend the exclusivity period.

A tax insurance policy was put in place to insure the buyer against the tax liability risk as a result of the restructuring not being treated as a tax-free transaction. The tax insurance policy had a $50 million limit and a seven-year term, and was bound within the remaining 10 days of the exclusivity period, which allowed the sale and purchase agreement to be executed within the remaining window. The deal closed several weeks later.

E. Example F – Tax Free Spinoff

A public company client, which was a leading foreign multinational in the manufacturing industry, spun off a U.S. business unit. Less than a year later, the client sold that unit to a private equity firm. IRS policy limited the ability of the taxpayers to obtain “comfort” rulings on wither the spin-off transaction qualified for tax-free treatment under Section 355 of the Tax Code. For example, the IRS will not rule on certain key technical aspects such as the “business purpose,” “device” and Section 355(e) “plan requirements.” The potential tax liability was approximately $270 million.

Due to the magnitude of the risk, the client sought a tax insurance policy to protect against a successful IRS challenge of the tax-free nature of the spin-off. Aon Transaction Solutions structured and secured the largest tax insurance policy placed in the previous decade for a $350 million limit, with a $5 million retention and a seven year term. The tax opinion policy covered (1) the full amount (less the retention) of potential U.S. federal and state income taxes, plus interest and penalties, following a successful challenge by the IRS, and (2) a “gross-up” (up to the $350 million limit) for the tax on any proceeds received by the client under the tax opinion policy.

V. **Claims**

Because the use of RWI has become widespread, substantial data is now available regarding the types of claims most likely to arise in connection with these policies. The following are brief summaries of Aon’s and AIG’s respective experience from claims under RWI policies.

A. Aon’s Experience

Aon’s transactional liability insurance clients in North America seem to be experiencing claims with a frequency that matches the increased use of the insurance solution in M&A transactions. Claims under RWI policies that incepted since 2014 result most frequently from breaches of representations relating to financial statements (25%), followed by claims relating to employment (16%), tax matters (14%), intellectual property matters (9.5%), product liability and recall (6%), and environmental (2%). The remainder of the claims encompass other (25%)

breach types (e.g., contracts, compliance). When considered on an annual basis, approximately 18.5% of deals in 2014 with RWI policies gave rise to claims, and the figures were similar for other years, at 17% for 2015 policies and 17% for 2016 policies. Thus far, 8% of 2017 policies have given rise to claims notices.

In total, since 2014, there have been 137 claims under Aon R&W policies – 124 total claims arose in buy-side policies (15% of buy-side policies) and 13 total claims arose in sell-side policies (30% of sell-side policies). Of 137 claims since 2014, 77 remain open and are early in the claims process, 16 were resolved within the applicable retention, 30 have been inactive/dormant, 10 resulted in loss payment and just 4 were ultimately denied by the insurer.

B. AIG's Analysis

AIG's data[3] was similar to Aon's in several respects, but broke claims down into different categories. AIG's analysis conformed to that of Aon with respect to breaches of reps relating to financial statements being the most likely category of rep likely to give rise to a claim (at 20% of all such claims under AIG RWI policies). This was followed by claims relating to compliance with laws (15%), breaches of representations relating to contracts (14%) and tax matters (14%), intellectual property (8%) and employment matters (8%), breaches of fundamental representations (7%), and finally environmental issues (5%), litigation (5%) and operations related matters (5%). In AIG's analysis, approximately one in five policies issued globally (21%) had claims presented thereunder. When 2015 is included in the relevant period, the ratio falls to 18%.

VI. Conclusion

RWI is now an accepted means for buyers and sellers in M&A transactions to "bridge the gap" in negotiations relating to representations and warranties and related mechanisms for recovery. More broadly, transactional insurance has developed to address and solve for an increasingly broad slate of M&A risk-allocation issues. Given the continued robust interest from insurers and buyers and sellers alike, forecasts project continued growth in the years to come.

[3] AIG Mergers & Acquisitions 2017 Claims Report, available at https://www.aig.com/business/insurance/mergers-and-acquisitions/mergers-acquisitions-claims-reports