Insuring the Deal: Key Considerations when Utilizing Transactional Insurance

May 15, 2019

Overview

- Introduction to Representation and Warranty Insurance ("RWI")
- Market Data
- Market Developments
- "No Seller Indemnity" Structure
- Claim Process and Procedures
- RWI for Public Deals and Other Insurance Products

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Introduction to Representation and Warranty Insurance

Overview

- RWI provides coverage for financial losses resulting from breaches of representations and warranties made by target companies or sellers contained in purchase agreements
- Protects an insured from unanticipated (unknown) losses that may arise subsequent to the closing
    - Preserves deal value by shifting risk of loss to insurer for fixed cost
- Generally covers all (or substantially all) representations in the purchase agreement as well as a pre-closing tax indemnity
    - Certain representations and warranties are more closely scrutinized by insurers and may be addressed through increased due diligence or exclusions
- RWI can extend an indemnification package (e.g., excess coverage) or serve as the buyer's sole resource for recovery
- Buyer side and seller side policies are available, although buyer side policies are much more popular

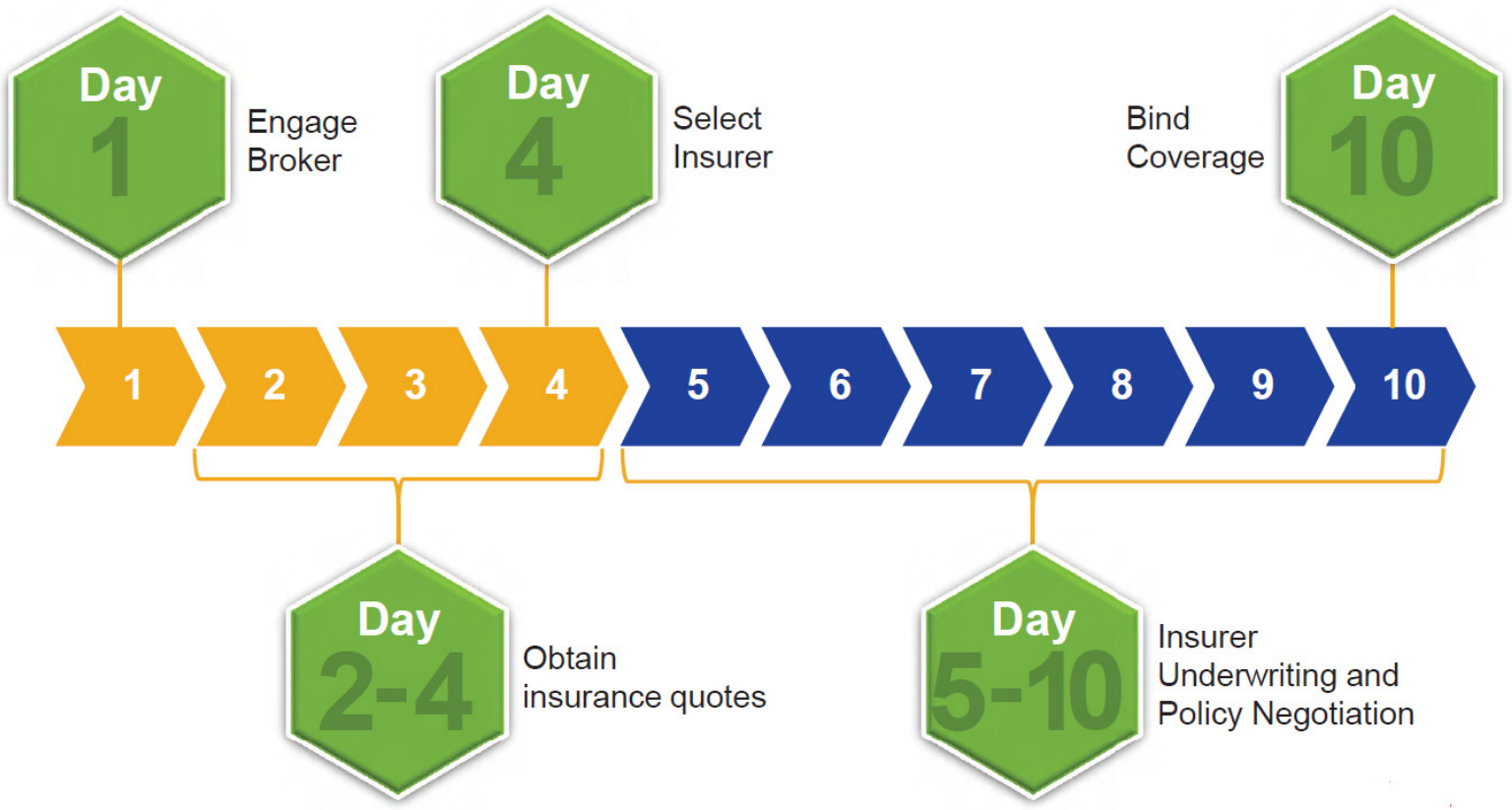
What RWI Does and Does Not Do

- What RWI Does:
  - Provides coverage for unknown breaches of reps and warranties in the purchase agreement, often with meaningfully longer survival periods than a seller is customarily willing to provide
  - Typically provides coverage for pre-closing standard tax audit risk
- What RWI Does Not Do:
  - Provide a "plug-and-play" wholesale replacement for a traditional seller indemnity
  - Provide coverage for seller's covenant breaches
    - However, it is possible to re-characterize certain covenants as representations and warranties – for instance, the seller's interim operating covenants can often be covered through a closing bring-down of the seller's absence of changes representation
  - Provide coverage for known risks or for areas of risk that are particularly difficult to diligence

Benefits of RWI for Buyers

- Risk Management Benefits:
  - Increase maximum indemnity (clients can purchase as much insurance as they feel necessary) and extend survival period of representations and warranties (policies generally survive for longer periods than in the acquisition agreement)
  - Eliminate seller post-closing credit/collection risk (e.g., multiple sellers, foreign sellers, insolvent sellers)
  - Provide recourse when no seller indemnity is possible (e.g., public company sales, bankruptcy or distressed situation)
- Strategic Benefits:
  - Distinguish bid in auction (i.e., be viewed as more attractive bidder) - reduces complexities of negotiating indemnification provisions with sellers
  - Protect key relationships (e.g., management)
  - If RWI policy is the buyer's sole recourse, the seller is generally willing to provide a more fulsome representation and warranty package

Process and Timing



Policy Exclusions

- Certain matters are excluded from coverage in virtually every policy, including:
  - Matters known to the deal team of the insured buyer
  - Uninsurable fines and penalties
  - Pension underfunding
  - Asbestos/PCBs/CFCs/USTs
  - Value of deferred tax assets
  - Collectability of accounts receivable
  - Payments pursuant to purchase price adjustments
  - Forecasts and forward looking statements

Policy Exclusions – Interim Breach

- Interim Breach
  - In a transaction involving a staggered sign-and-close, most policies include an exclusion for losses arising from an "Interim Breach" which a breach in which:
    - the facts and circumstances that caused the breach occurred between signing and closing (the "interim period"); and
    - a member of the buyer's deal team obtained actual knowledge of the breach during the interim period
  - For policy drafting purposes, try to limit interim breach to only include breaches where all of the facts that caused the breach first occurred during the interim period
  - In practice, interim breaches are rare, but consider the interplay between the interim breach exclusion and the closing condition regarding the seller's reps

Enhanced Diligence Areas

- Often, insurers will designate certain areas as “enhanced due diligence areas”
- While not a blanket exclusions, insurers are signaling to the buyer that they have certain underwriting concerns regarding these areas and that they will focus on the buyer’s diligence findings before determining whether to provide coverage
- Common “enhanced due diligence areas” include:
  - Wage and hour matters
  - Cyber security/privacy
  - Products liability
  - Professional services liability
  - Condition of assets
  - Unaudited financial statements
- Depending on the target’s risk profile in the foregoing areas, certain carriers may insist on a blanket exclusion for some of these categories regardless of the results of the buyer’s diligence

Environmental Coverage

- Available RWI coverage for environmental reps varies based on the target's environmental risk profile, as well as each individual carrier's appetite to insure environmental matters
- Environmental coverage options range from:
  - No coverage (i.e., the carrier excludes environmental coverage entirely)
  - Coverage on an "excess" basis, meaning that the insurer will provide coverage for a breach of the environmental reps, but only (i) to the extent the loss would be covered by an existing environmental policy and (ii) once the coverage under such underlying environmental policy has been exhausted
  - Full coverage
- Where environmental coverage is available, it is almost always a heighted area of diligence
- RWI environmental insurance coverage is not the same as an environmental policy. If buyers have environmental concerns regarding the target, they should strongly consider a stand-alone environmental policy

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Market Data

Market Developments

- Transaction liability insurance carriers in 2014:

Market Developments

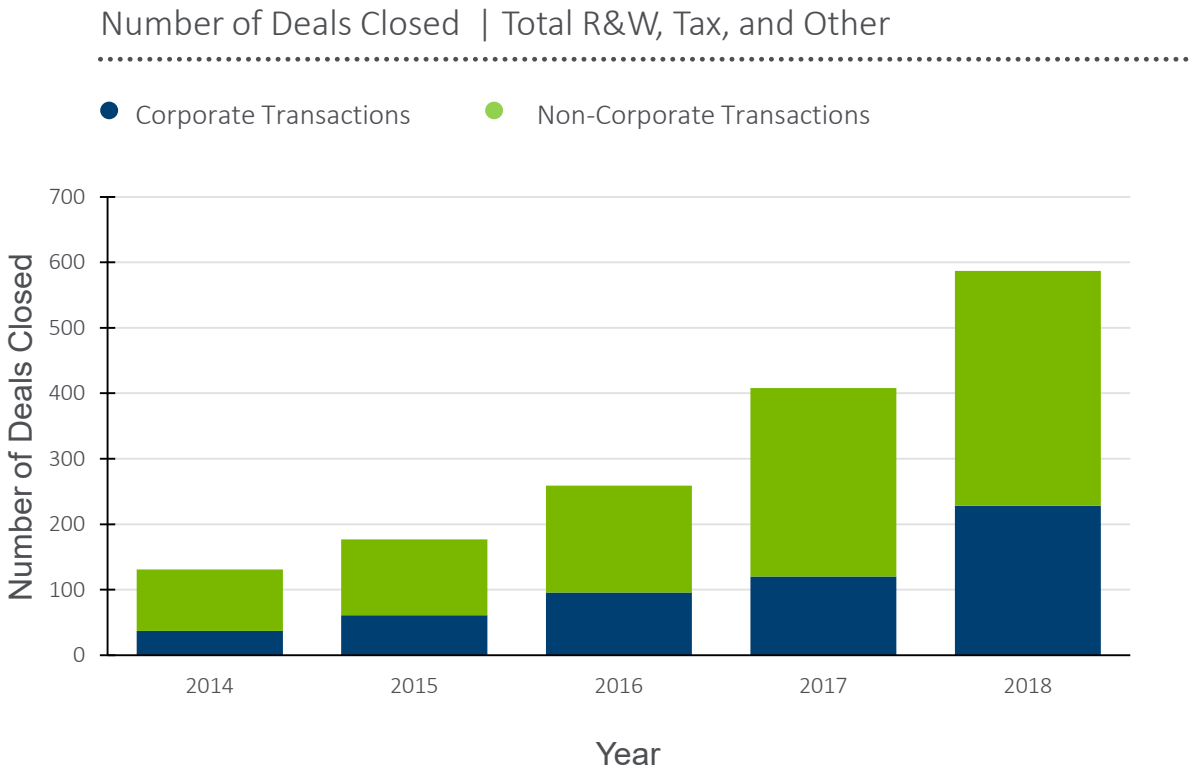
- Transaction liability insurance carriers in 2019:

Market Developments

34% of North American deals used representations & warranties

Aon estimates

More than **75%** of private equity/financial sponsor deals utilized R&W insurance



Market Developments: More Innovative Insurance Solutions

- Broader Coverage
  - Generally, no restrictions on industry sector
    - Some industries such as healthcare used to be challenging to insure, but certain carriers have developed expertise in these areas and are now able to offer fulsome coverage
    - Insuring title on upstream oil and gas transactions can be challenging, although recent innovative products have been introduced to address this issue
- Streamlined Process
  - Insurers / brokers are staffed by former M&A attorneys who work on deal timelines
- Fewer Exclusions
  - Competitive market dynamics have forced insurers to narrow and eliminate exclusions

Market Developments: More Innovative Insurance Solutions

- Increased Limits of Liability
  - Individual insurers generally cap coverage between $25 million and $50 million
  - However, limits in excess of $350 million are available by stacking policies, and coverage of up to $1.5 billion is achievable
- Flexibility to Insure Smaller Deals
  - Some carriers are willing to insure transactions as small is $10 million, although the cost of these smaller policies on a percentage basis is higher
    - Minimum coverage amounts are generally $3 million and carriers still charge an underwriting cost of $30,000-$40,000
- Reduced Premium Rates and Deductible Levels
  - Total costs are typically 2.5%-3.5% of the policy limit (and even lower for larger deals)
  - Currently standard retention amounts are 1.0% of enterprise value on transactions of up to $500 million, and .75% of enterprise value on transactions in excess of $500 million, generally stepping down to 0.50% over time (usually 12 months following closing)

Market Developments: More Innovative Insurance Solutions

- Limited Coverage for Interim Breach
  - A small number of carriers will provide coverage for interim breach on transactions with a brief period of time between singing and closing (generally no more than 45 days) at a cost of $25,000-$50,000
  - Other markets will allow for erosion of the retention up to a threshold (i.e., 25% of the retention amount) for non-covered loss, including interim breaches
- Coverage Enhancements for Fundamental Representations
  - Some markets will provide lower (and sometimes nil) retentions for breaches of fundamental reps
  - Coverage for fundamental reps and taxes available on an excess basis at a significantly reduced rate (0.75% of the coverage amount or less)
- Coverage for Non-Control Transactions
  - Ability to insure transactions where the buyer is acquiring a non-controlling interest in the target (i.e., joint ventures, preferred equity investments)

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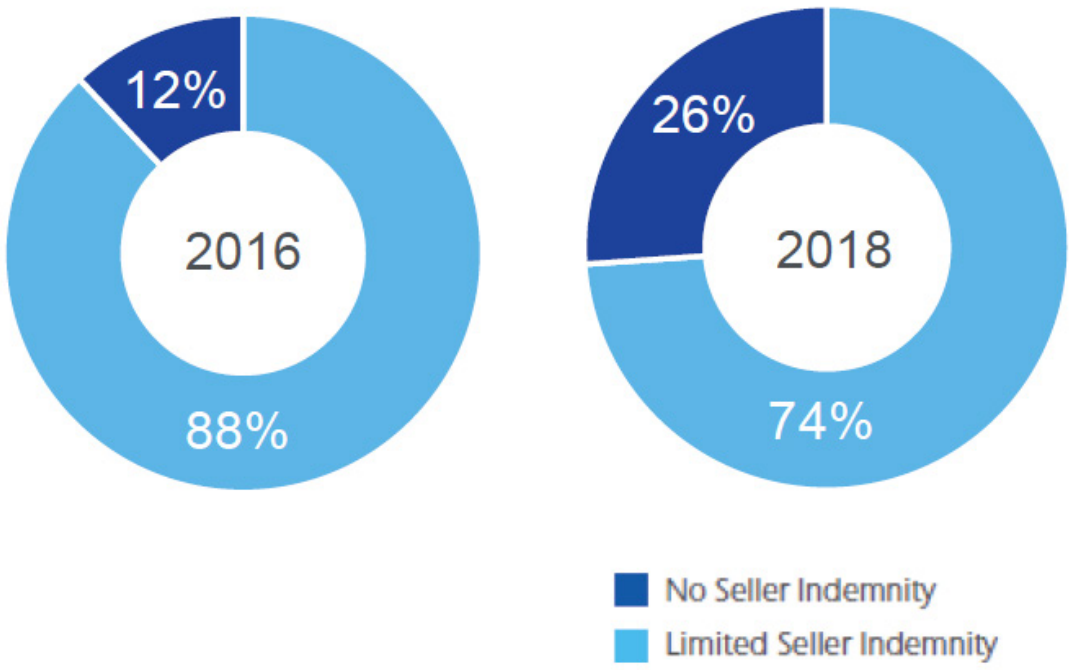
“No Seller Indemnity” Structure

"No Seller Indemnity" Structure

- It is increasingly common for the parties to agree to completely eliminate the seller's liability for rep breaches (i.e., the seller's representations and warranties do not survive the closing). In those transactions, the seller does not indemnify the buyer for breaches of such representations following the closing, and the buyer looks solely to an RWI policy to recover losses from such breaches.
- Most insurers are now willing to offer the same coverage limit, initial retention, drop-down retention and scope of coverage in a deal *without* a seller indemnity as in a deal *with* a seller indemnity
  - Most insurers will impose a modest premium increase (generally $15,000-$50,000) to reflect the perceived moral hazard of a no-seller indemnity transaction structure

"No Seller Indemnity" Structure: Trends

- Reflecting industry trends, Aon observed that the popularity of "no seller indemnity" policies increased from 2016 to 2018:



Development of "No Seller Indemnity" Structure

- When RWI first gained market acceptance, policy retention amounts were routinely 1.5%-2.0% of the purchase price
- It became routine for the buyer and seller to "split" the retention amount, meaning the buyer would be responsible for the first 0.75%-1.0% of losses (replicating a customary "basket" amount in a seller indemnity deal), the seller would indemnify the buyer for the next 0.75%-1.0% of losses, and the buyer would then look to the RWI policy for any further losses
- A prolonged sellers' market initially incentivized buyers to propose no seller indemnity deals in competitive processes to distinguish their bids, and no seller indemnity structures are often proposed in competitive auctions as a matter of course
- Additionally, as retention amounts have decreased to 0.75%-1.0% of enterprise value, the benefit to a buyer of "splitting" the retention has decreased
  - Buyers often don't see value in negotiating an indemnity section and forming an escrow for an indemnity of 0.375%-0.50% of purchase price

"No Seller Indemnity" Structure: Buyer Benefits

- While the "no seller indemnity" structure has obvious benefits for the seller, there are also several benefits for the buyer:
  - The use of a no seller indemnity structure may enhance the buyer's coverage under the policy:
    - "Full Materiality Scrape" – most policies will "read out" materiality qualifiers in the representations and warranties for purposes of determining whether a representation has been breached and the amount of losses resulting from such breach. However, in deals with a seller indemnity, most policies will only read out materiality for purposes of the reps if the acquisition agreement includes a full materiality scrape
    - "Damages Exclusions" – the policy will generally not independently impose broad damage exclusions, such as exclusions for consequential damages and damages based on multiples of earnings and lost profits, unless those exclusions are included in the Loss definition in the underlying purchase agreement
  - Accordingly, seeking a seller indemnity can jeopardize the buyer's efforts to obtain coverage enhancements under the policy, since the seller may resist a materiality scrape or insist on exclusions for certain categories of damages in the purchase agreement with respect to its indemnification obligations

"No Seller Indemnity" Structure: Buyer Benefits (cont.)

- By eliminating the need to negotiate an indemnification section, the use of RWI can meaningfully shorten negotiations with respect to the acquisition agreement, which can be an important factor in a competitive process
- The seller is generally willing to expand the substantive coverage of the representations in the acquisition agreement and to reduce the use of knowledge qualifiers, thereby improving the buyer's basis for recovery under the policy
- Eliminating post-closing recourse for rep breaches helps preserve relationships with the seller after the closing, which is especially important if the seller is a member of the management team or is a party to a transition services agreement
- Less burdensome recovery – when a claim arises in a "no survival" deal, the buyer can work with a stable, creditworthy insurer to process the claim, rather than having to fight the indemnity claims on two fronts in order to also obtain recovery from the seller (who is only liable for a relatively smaller amount); no concern about seller controlling third-party claims in which it has little at stake

"No Seller Indemnity" Structure: Limitations

- Known contingent liabilities identified during the buyer's diligence will not be covered under an RWI policy — if the buyer is not willing to bear the risk for those liabilities, the parties may still need to spend meaningful time negotiating special indemnities for those matters
- The buyer remains exposed to extraordinary losses in excess of the coverage limit from breaches of fundamental representation
  - In a transaction with a seller indemnity, the seller might agree to indemnify the buyer for losses arising from fundamental representation breaches in excess of the policy coverage limit
  - In a true "no survival" deal, however, the buyer may not be fully compensated for its losses in the event of a breach of the sellers' fundamental representations
- The buyer's diligence poses a "Catch-22" in a no seller indemnity transaction: the buyer will want to conduct a comprehensive diligence process so that it is fully aware of all of the target's risks, but doing so will deprive the buyer of coverage under the policy for any liabilities that it uncovers

"No Seller Indemnity" Structure: Limitations (cont.)

- Coverage for pre-closing taxes is generally more limited than a standard seller pre-closing tax indemnity
  - RWI policies will cover the tax representations in the acquisition agreement, as well as a standalone pre-closing tax indemnity
  - However, pre-closing tax coverage will be limited to coverage for taxes that the buyer doesn't know about when the policy is bound
    - For example, accrued taxes for pre-closing periods that are not yet payable would not be covered under the policy, even though such taxes typically would be covered under the seller's standalone pre-closing tax indemnity
  - This leaves the parties with a few options
    - Retain a stand-alone seller pre-closing tax indemnity to "backstop" the coverage under the policy
    - Have seller agree to pay taxes on unfiled pre-closing tax returns as they come due
    - Estimate accrued pre-closing taxes as part of the purchase price adjustment and reduce the purchase price accordingly

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Claims Process and Procedures

Claim Percentages

- Aon has been notified of 249 R&W claims on policies placed beginning in 2013

Claim Percentages

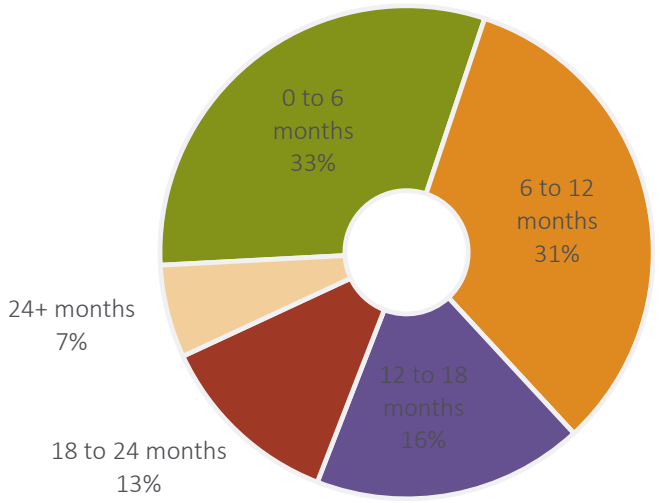
Representation & Warranties Policies

Buy-side
- 229 Claims
- 14% policies

Sell-side
- 20 Claims
- 42% policies

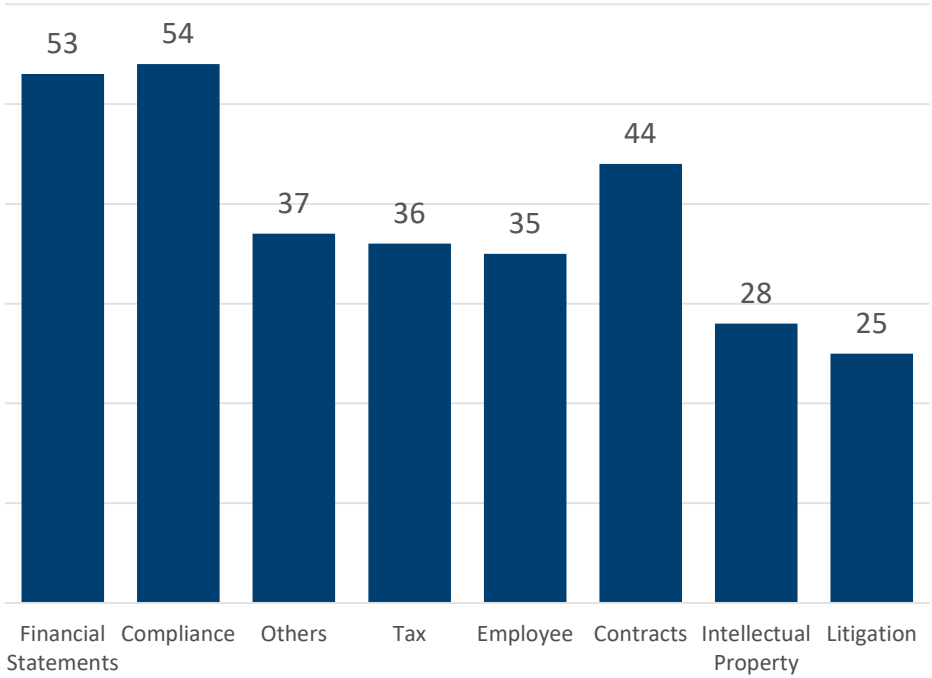
Trends in Claims

Trends in Claims: Closing to Claim Notice



Median: 15 Months
Mean: 10 Months
Range: 3 days - 53 months
Interim Claims: 10

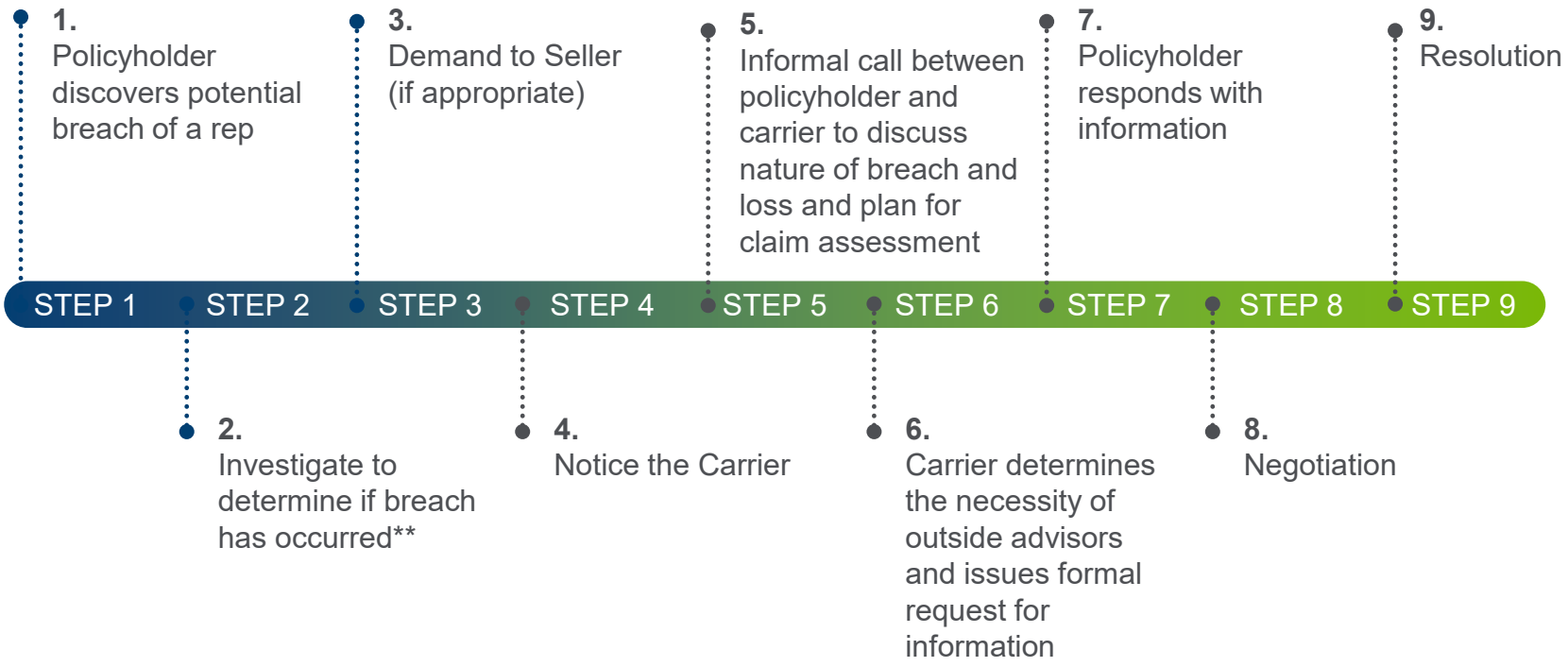
Types of Breaches



Examples of "Other"

- Environmental: 8
- Product Liability/Recall/Warranty: 10
- Condition of Assets: 9
- Healthcare: 4

Timeline of a Claim (Buyer-Side Policy)



Takeaways: What are Insurers Evaluating?

- Is there a breach of a specific representation under the purchase agreement?
- Are there applicable exclusions?
- Did an identified party have actual conscious knowledge of the alleged breach?

- Is the loss recurring or one-time?
- How should the loss be calculated?
  - Multiple of EBITDA if that is how deal was valued? (Create a record of the multiple)
  - Diminution of value?
  - Dollar for dollar?
- How can the insured validate the amount of loss?
- Can the loss be mitigated or is there an offset ?

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RWI for Public Deals and Other Insurance Products

RWI for Public Deals

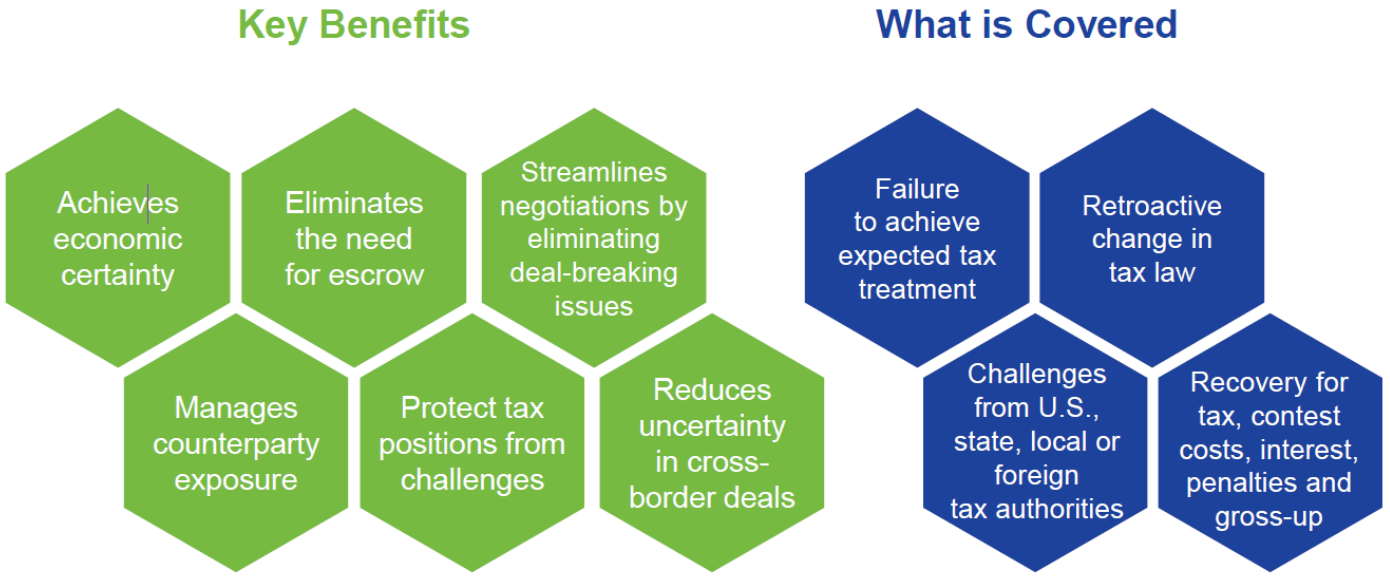
- Generally speaking, there is no seller indemnification in public transactions. However, buy-side RWI policies can provide the buyer with a source of recovery for breaches of the target's reps in the merger agreement.
- Historically, use of RWI in public company deals has been limited for reasons including
  - Confidentiality concerns with soliciting quotes for RWI before a public deal is announced
  - Challenges with including a "materiality scrape" in the policy where the target's reps are heavily qualified by material adverse effect (and disclosure schedules are therefore sparsely populated when compared to private deals)
  - Timing concerns in public company transactions that often move very quickly

RWI for Public Deals (cont'd)

- Carriers are willing to place RWI policies following the signing of the merger agreement, alleviating timing on confidentiality issues that accompany binding a RWI policy pre-signing
- Even with MAE qualified reps, insurers are willing to include a full materiality scrape, although it is often accompanied by a materiality threshold for purposes of making a claim (much like a de minimis claim amount)
- The target's reps will be qualified by public disclosure, and carriers will generally be unwilling to insure reps regarding the adequacy/accuracy of the target's SEC disclosure

Tax Liability or Tax Opinion Insurance

- "Tax Liability" or "Tax Opinion" insurance protects buyers against a successful challenge by the IRS or other foreign, state or local tax authority
- Policy pays tax, interest, penalties, contest costs and gross up



Tax Liability or Tax Opinion Insurance (cont.)

- Tax insurance can be applied to the following:
  - S corporations
  - Reorganizations (tax-free and taxable)
  - Section 355 spin-offs
  - REITs/real estate acquisitions/sales
  - NOL carryforwards
  - Partnership issues
  - Employee benefits issues
  - Federal and state tax credits (renewable energy, LIHTC, historics)
  - Cross border and international issues
  - Tax risk management (no transaction needed)
- Tax shelters (listed transactions) are not insurable

Litigation Insurance

Pending or potential litigation can expose buyers to significant risks and financial liability. Litigation insurance can offset that risk or limit the liability buyers will be responsible for once the deal is complete.

M&A Deals

- Helps sellers avoid substantial escrow requirements
- Allows buyers to ring fence the cost of damages from an adverse judgement

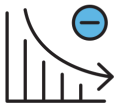
Ongoing Business Risk Management

- Protects companies from catastrophic loss from an adverse judgement

When to consider Litigation Insurance

Possibility of a catastrophic outcome

Pending litigation is preventing a deal from closing



Significant delta between likely range of damages and amount sought by plaintiff

Litigation record is well developed

Litigation Insurance: Insuring Against the Risk of Non-Reversal on Appeal

Client Challenge

Background

- Client lost a $20M+ compensatory and punitive damage judgment following entry of a default judgment against it and a subsequent trial rife with reversible errors.
- The judgment was impeding client's PE owner from selling the company, and client's cash position was compromised both because it was forced to put up significant cash collateral to bond its appeal and because its lenders had severely restricted its borrowing ability.

Obstacle

- Although the Court had committed numerous reversible errors, the client allegedly had engaged in unsavory behavior in connection with the litigation.
- Even when a case should be reversed, there is no certainty that the appellate court will do the right thing.

Solution

Aon structured an appellate risk policy that capped the client's exposure if the appellate court does not overturn the judgment, thus allowing client to recoup some of the cash collateral and to reopen its lines of credit so that it could make an acquisition.

Coverage

Amounts in excess of the retention for a final, non-appealable judgment affirming the trial court judgment.

Limit & Premium

$12.6M x/s $8M retention.

Litigation Insurance: Insuring Buyer Against an Early Stage Patent Infringement Lawsuit

Client Challenge

Background

- Buyer was negotiating the acquisition of a small competitor in an industry roll-up transaction.
- Target had just been sued for patent infringement by the buyer's chief competitor.
- Client believed that the lawsuit was a means to try to scare the target into selling to the competitor rather than the buyer.

Obstacle

- Even though the buyer believed the litigation to be baseless and badly wanted to close the transaction, it was unwilling to do so without an escrow indemnity from the target's shareholders.
- Target's shareholders, in turn, did not want to put up an indemnity because they too believed that the lawsuit was baseless, and the target was prepared to scuttle the acquisition and defend the case.
- Litigation was in earliest stages, with only a complaint and no responsive pleadings.

Solution

Because the case was at its inception, Aon worked with the client to prepare an analysis of the likely downside risk of royalty and lost profit damages so that potential insurers would be able to propose a retention that would both protect the buyer from catastrophic loss and protect the insurers from providing coverage within a likely range of damages.

Coverage

Issued judgments-only coverage for a patent infringement lawsuit.

CFIUS Reverse Break Fee Insurance

- CFIUS is the Committee on Foreign Investment in the United States and is charged with identifying and mitigating U.S. national security risks arising from foreign investment in U.S. businesses
- CFIUS is comprised of 13 executive branch agencies, 9 of which have voting power, and transactions are subject to review by CFIUS when they result in foreign "control" of a U.S. business (including U.S. operations of non-U.S. companies)
- CFIUS prefers and is entitled to review certain prospective acquisitions, and is authorized to review transactions after they have closed under certain circumstances

CFIUS Reverse Break Fee Insurance (cont.)

- CFIUS Reverse Break Fee Insurance enables certain foreign buyers to participate in auctions and other sales of U.S. businesses that they might not consider in the absence of insurance
  - Often, Chinese and other foreign buyers are not willing to shoulder the risk of paying reverse break fees in the event of a failure to receive approvals from CFIUS, even when they are receiving solid advice that they should receive approval
- Insurance expands the universe of potential buyers of U.S. businesses that sellers may access to include foreign buyers that would not agree to undertake the payment of a reverse break fee triggered by their failure to obtain CFIUS approval

CFIUS Reverse Break Fee Insurance: Coverage

- CFIUS Reverse Break Fee Insurance covers a buyer when: (a) CFIUS intends to issue a report recommending that the President of the United States prohibit the acquisition unless the buyer withdraws its application for CFIUS approval, (b) the President issues an order prohibiting the acquisition and (c) the "outside date" under the acquisition agreement is reached and CFIUS approval has not been obtained
- The covered loss under the policy is the amount of the CFIUS reverse break fee, less any self-insured retention or deductible, plus other broken deal costs, such as attorneys' fees, investment banking fees, financing costs and other diligence costs

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Panelist Profiles

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Matthew B. Dubeck is a partner in the Los Angeles office of Gibson, Dunn & Crutcher, where he practices in the firm's Mergers and Acquisitions, Private Equity and Securities Regulation and Corporate Governance Practice Groups. He advises companies, private equity firms and investment banks across a wide range of industries, focusing on public and private merger transactions, stock and asset sales and joint ventures and strategic partnerships. Mr. Dubeck also advises public companies with respect to certain corporate governance matters.

In 2017, Mr. Dubeck was recognized by *Law360* as a Rising Star in the area of Private Equity. Prior to joining Gibson, Dunn & Crutcher, Mr. Dubeck was an associate with Hogan & Hartson in Washington, D.C. He was a judicial clerk for Judge Julia Smith Gibbons of the United States Court of Appeals for the Sixth Circuit and a judicial intern for Judge Ellen Segal Huvelle of the United States District Court for the District of Columbia.

Mr. Dubeck received his law degree, *magna cum laude*, from Georgetown University Law Center in 2005, where he was elected to the Order of the Coif and served as Managing Editor of the *Tax Lawyer*. He received a Bachelor of Science degree in Computer Science, *cum laude* with distinction, from Yale University in 2001. Prior to attending law school, Mr. Dubeck was a Program Manager with Microsoft Corporation, where he designed search engines and natural user interfaces.

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Mr. Whalen's practice focuses on a wide range of corporate and securities transactions, including mergers and acquisitions, private equity investments, and public and private capital markets transactions. In 2018, D CEO magazine and the Association of Corporate Growth named Mr. Whalen a finalist for the 2018 Dallas Dealmaker of the Year.

Mr. Whalen received his law degree summa cum laude in 2009 from the SMU Dedman School of Law, where he was a member of the Order of the Coif and served as an Articles Editor on the SMU Law Review. He earned his Bachelor of Science degree summa cum laude and his Masters of Business Administration degree from Louisiana Tech University.

Mr. Whalen is a member of the Texas Bar and admitted to practice in the State of Texas.

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Matthew Wiener is the head of Aon's Transaction Liability team for the Southwest region and the national leader for its energy practice. In this role, Mr. Wiener is responsible for the development and implementation of transactional-based risk solutions, including the deployment of insurance capital for M&A transactions through representations and warranties, litigation, tax and other contingent liabilities insurance. Mr. Wiener is based in Houston and is further supported by a New York-based team of 20 professionals in North America and colleagues in London, Hong Kong, Sydney and Bermuda who focus exclusively on transactional risk transfer.

Prior to joining the Aon Team, Matthew was an attorney at Vinson & Elkins LLP, where he specialized in corporate finance and securities law matters, including mergers and acquisitions, private equity, public and private securities offerings, divestitures, and general corporate representation, with a significant focus in the energy sector.

Matthew is a graduate of The University of Texas with a BBA in Finance and Georgetown University Law Center with a Juris Doctorate degree.