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GUIDE 2023

MERGERS AND ACQUISITIONS

Navigating challenging waters

Perfecting Governance

IN ASSOCIATION WITH:

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Acknowledgements

Francis Kean joined McGill and Partners in 2020 bringing with him thirty years of experience in the industry. Francis is a Partner within the Financial Lines team. Previously, he was a partner at the law firm Barlow Lyde and Gilbert. Francis has handled a wide variety of financial lines claims for both insurers and clients, and has considerable experience of drafting policies and advising all parties in connection with coverage issues. He is a frequent author and speaker on liability issues affecting boards.

Edward Ring is a Partner in McGill and Partners' Mergers and Acquisition team, focusing on the placement of M&A insurance for complex and cross-border transactions in Europe, LatAm and North America. Edward specialises in transactions involving US clients investing into Europe and has particular experience in the metals and mining and life science sectors. Prior to joining McGill and Partners, Edward was a broker in Aon's M&A and Transaction Solutions practice, having advised on a variety of global transactions across a wide range of sectors.

McGill and Partners is a boutique specialist (re)insurance broker focused on large clients and/or those with complex and/or challenging needs. Launched in 2019, the firm has significant backing from funds affiliated with Warburg Pincus, a leading global private equity firm. McGill and Partners is a British based firm, headquartered in London with international presence in New York, Miami, Chicago, Bermuda, Switzerland, Germany, Sydney and Dublin.

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The leading UK association for everyone who has a responsibility for risk management and insurance in their organisation, Airmic has over 450 corporate members and more than 1,800 individual members. Individual members are from all sectors and include company secretaries, finance directors, and internal auditors, as well as risk and insurance professionals. Airmic supports members through learning and research; a diverse programme of events; developing and encouraging good practice; and lobbying on subjects that directly affect our members and their professions. Above all, we provide a platform for professionals to stay in touch, to communicate with each other, and to share ideas and information.

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GUIDES

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01 Introduction

In a Spring 2023 poll of FTSE 250 chief executives, 94% expected to make acquisitions during this year (up from 86% last year). The same poll found that 88% of FTSE directors regard British companies as vulnerable to takeovers. This comes at a time when several listed companies have disclosed that they have been targeted by private equity firms looking to take them private and this trend looks set to continue as debt markets recover.

Against the backdrop of persistent market volatility and uncertainty surrounding the likelihood of a global recession, boards are more focused than ever on cash flows and the financial health of each of their organisation's divisions. Divestures of non-core assets through corporate carve-outs are already a popular feature of the M&A landscape as businesses look to streamline. At the same time, competition and security concerns and the regulations to which they give rise, including the recent National Security and Investment Act, could act as a barrier to deal-making.

Mergers and acquisitions present boards with a myriad of threats and opportunities, among which one of the few certainties is that remaining on the sidelines is not a realistic option. That is as true for profitable companies with substantial cash reserves as it is for companies experiencing more challenging trading conditions. The UK has largely avoided the surge of litigation in the US in which allegations that companies either paid too much to acquire other companies or allowed themselves to be bought too cheaply were commonplace. Nevertheless, that risk still exists. One of the most notorious examples is the transatlantic takeover by Hewlett Packard of Autonomy plc in the UK. The consequences of that still linger on with the unsuccessful battle by Mike Lynch to fight extradition to the US to face charges of wire fraud (among others) following one of the largest civil fraud cases ever in the UK.

"M&A activity offers the opportunity for spectacular growth and expansion, but also carries the threat of damaging shareholder value and litigation if things go wrong. The aim of this guide is to provide a high-level roadmap for board members, to help them navigate this complex landscape."

Francis Kean – Partner, Financial Lines, McGill and Partners

> "A lack of symmetry between Corporate Purpose and Culture can lead to the failure of even the most logical mergers and acquisitions viewed purely through the lens of balance sheets. Culture has staying power long after the ink of signatures on the deal have dried. Consequently, when M&A risk assessments are organised, the people issues must not be underestimated and must be factored in the overall profile of risks and opportunities."
>
> *Julia Graham – CEO, Airmic*

How should boards navigate these challenging waters? What balance should be struck between seeking opportunities and preparing for threats? If planning a programme of divestiture, what might the potential ESG or extended supply chain implications be? For example, the decision to outsource debt collection for large customer or consumer-facing businesses can still have significant reputational impact as was recently demonstrated in the UK energy sector. To what extent can insurance mitigate both the liability risks faced by companies engaged in M&A activity and those of the directors on whose boards they sit? The aim of this Guide is to provide a toolkit to assist directors in understanding and keeping pace with this fast-changing and increasingly complex landscape. It takes the form of 12 questions designed to break the diverse set of issues down into a manageable series of topics. The list is not exhaustive and answers to each question will vary tremendously depending on the size, maturity and nature of an organisation's operations. Nevertheless, in response to each question, we identify a range of issues which are likely to be relevant.

1 Judged against the overall organisational purpose, how do I gain comfort that the organisation regularly evaluates merger and acquisition-related opportunities and the challenges associated with their execution?

Whether during times of uncertainty or robust financial performance, M&A provides businesses with opportunities to expand into new markets, acquire talent, remove competition, access new intellectual property or technology, or divest assets to focus on the organisation's core offering. To appropriately consider opportunities, the benefits of any acquisition or sale need to align with and help facilitate the organisation's strategic goals. It is therefore important for the company to be clear about its short, medium and long-term objectives before considering whether M&A can be utilised to facilitate such goals.

Evaluating opportunities in the market requires extensive research and time commitment.
A dedicated corporate development team provides businesses with internal resource that intimately understands the organisation's strategic ambitions, but this may not be a suitable option for all businesses. Working with a financial adviser in the business of scouting for potential acquisition targets (or potential divestment opportunities) will provide significant experience and sector expertise that is otherwise unavailable internally.

A key consideration both at the outset and throughout any integration process (and one often not given the attention it deserves) is cultural alignment between the acquirer and the target. Assessment and measurement is not always easy. Well-timed and targeted questions by board members should help keep this important topic on the agenda.

Once an acquisition or merger plan has been formed, execution requires a robust due diligence exercise to evaluate the target's operating history. Legal, accounting, technical and other specialist diligence from third-party expert advisers (including ESG diligence, see question six for further details) will provide the full organisation's picture before a final decision is made.

2 Am I satisfied that an appropriate blend of expert advice and intelligence-gathering is in place, as to the attendant and fast-changing geopolitical, economic, regulatory and reputational issues?

Perhaps the key here is that the scope of initial research and enquiry in relation to potential acquisitions (and hence the questions which directors need to ask about the nature and depth of that research and enquiry) needs to be ever broader to accommodate an increasingly complex and evolving international business environment. Often it will be necessary to secure professional and expert advice on a range of issues. A blend of experience and backgrounds on the board will help ensure that the net of research and enquiry has been cast sufficiently and appropriately widely. These issues (which transcend acquisitions and often also relate, for example, to international supply chain risk) are addressed in more detail in the Airmic Boardroom Guide on that subject.

Relevant expertise should be at the heart of mergers and acquisitions. A deal might be a one-off experience for an organisation and consequently, there can be an absence of relevant corporate history.

3 Are there contingency plans in place to defend against hostile or unwelcome attention from potential acquirers?

There are a number of contingency plans you can deploy to make your organisation less desirable to potential acquirers. While you should always obtain legal advice to determine the best course of action (and the best course of action will depend on whether the organisation is a publicly listed or a private entity), you may wish to explore the following strategies:

- Dual class share structure: helps to ensure that directors and management retain control of the organisation even if they own only a minority shareholding, as other shareholders will not have the same rights (voting or otherwise) attached to their shares.

- Poison pill (shareholder rights plan): provides an option to issue new shares to existing or new shareholders, at a discounted price, to dilute the share value of the organisation, making it harder for the hostile party to acquire a majority shareholding.

- Golden parachute: contracts with key directors, officers and management that provide for a material pay-out (financial and other incentives) should their employment be terminated, making it challenging for potential acquirers to remove the management team upon acquisition.

In addition to these specific strategies, the importance of relationships with key stakeholders cannot be overstated. If employees, customers and shareholders have faith that the current management of the company is best suited to lead and grow the business, potential acquirers might wish to think twice about the potentially negative impact on valuation the acquisition would have on the organisation arising from a soured relationships and culture between the employees and the new owners.

4 If a divestiture programme is planned, have the supply chain implications been considered in respect of products or services which may no longer be performed in house but for which the organisation may still be reputationally exposed?

The decision to outsource aspects of a organisation's delivery of its products or services in order to concentrate on core purposes or for other operational reasons is often entirely legitimate and justified. That said, there are many examples of reputational damage being suffered by companies which, although they no longer engage in the relevant activity, are accused of having tolerated or even known about and actively encouraged malpractice within their supply chains. Indeed, on one view, a divestiture programme can exacerbate the risk of reputational damage precisely because of a reduced ability to exercise requisite oversight and control. For this reason, it is important to address these issues in the early planning stages of a divestiture programme, factoring in the risk of ongoing reputational damage and seeking to measure it against the potential benefit of divestiture. At board level (depending on the size and materiality of the planned programme), recording and minuting of the decision-making process is important.

5

If I am looking to sell non-core assets, have I considered the ongoing services that will need to be provided to the buyer as it integrates the acquired asset into its own operations?

Carve-out transactions can be complicated. The sale of non-core assets may come with a myriad of issues as a seller seeks to dislocate assets, people and intellectual property from its business. Unlike a corporate transaction, much of the crucial infrastructure that keeps a organisation or group operating day to day is shared throughout the business and its subsidiaries. Carving out part of that business presents unique challenges as buyers will need to ensure there is sufficient infrastructure in place from signing for the business to continue to function. A key focus for buyers, therefore, will be ensuring continuity of employee, IT and other shared services such as HR, benefits, payroll, software, servers, data storage, etc. Many of these services may continue to be provided by the seller by way of a transitional services agreement for a defined period of time while the buyer integrates the acquired business's operations into its own.

6 If an acquisition programme is planned, have I identified key metrics to evaluate the ESG credibility of the target companies I am exploring?

A organisation's ESG credibility has become a key consideration when evaluating the merits of an acquisition. Shareholders, financiers and other stakeholders have ESG considerations at the forefront of their agenda and it is paramount to ensure that this is considered during the due diligence process. ESG metrics can be subjective and will depend on the appetite and priorities of the acquirer.

There are a number of ways in which an acquirer can assess the ESG credibility of a target. Some may be more interested in environmental matters, whereas others may put more focus on social issues, with governance typically sitting across both of these topics. It is possible for acquirers to undertake specific ESG due diligence from reputable third-party advisers which can help scope ESG metrics to measure the credibility of the acquisition target, aligning with the company's own values and appetite. Where there are identified issues or a misalignment of values, a remediation plan can be implemented post-acquisition.

7 Do I have an understanding of my potential personal liability exposures as a director arising from M&A activity?

For most companies of any size, there is no shortage of resources available in the form of bespoke training courses, seminars and workshops offered by law firms on the subject of personal liability for board members both generally and specifically with respect to M&A activity. There is much to be said for directors gaining (and keeping up to date with) a general level of understanding of this topic outside the scope of any specific transaction.

There is or may be a perception that the risks of personal liability for directors really only come into play for publicly listed companies. It is certainly true that the additional legal, regulatory and listing rules-related burdens on directors created by this type of transaction can be significant. However, that risk is often somewhat mitigated by the fact that lawyers and other advisers well versed in this type of transaction will usually have been retained to advise both sellers and buyers. The reality is that the personal liability risk for directors is heightened almost irrespective of the particular mechanism chosen for any given merger or acquisition. This is due to the commercial reality that facts may emerge or events may occur after the transaction date which (albeit perhaps with the benefit of hindsight) call into question the commercial rationale and benefits of the deal, and therefore the competence and diligence of those responsible for its execution.

"There is much to be said for directors taking a little time – while there are no claims on the horizon – to understand what their D&O insurance covers, how it works in the context of M&A transactions and, perhaps equally importantly, what is not covered."

Francis Kean – Partner, Financial Lines, McGill and Partners

8 Is this something against which my Directors and Officers Liability insurance will protect me?

The short answer is that a D&O policy should in principle protect directors from merger and acquisition-related personal liabilities and fund their defence and legal representation expenses. As with many short answers, this one comes with some important caveats.

Firstly, there needs to be a valid policy in force at the time a claim is made against the director, rather than (as is sometimes thought) at the time the liability or alleged wrongful act occurred. This is a significant issue with the different D&O coverage solutions available for buyers and sellers, all of which need to be considered and implemented before the effective date of the transaction. In particular, the directors of the sold or acquired entity will typically wish to secure and arrange funding for an extended reporting period of at least six years in respect of claims relating to wrongful acts prior to the transaction date.

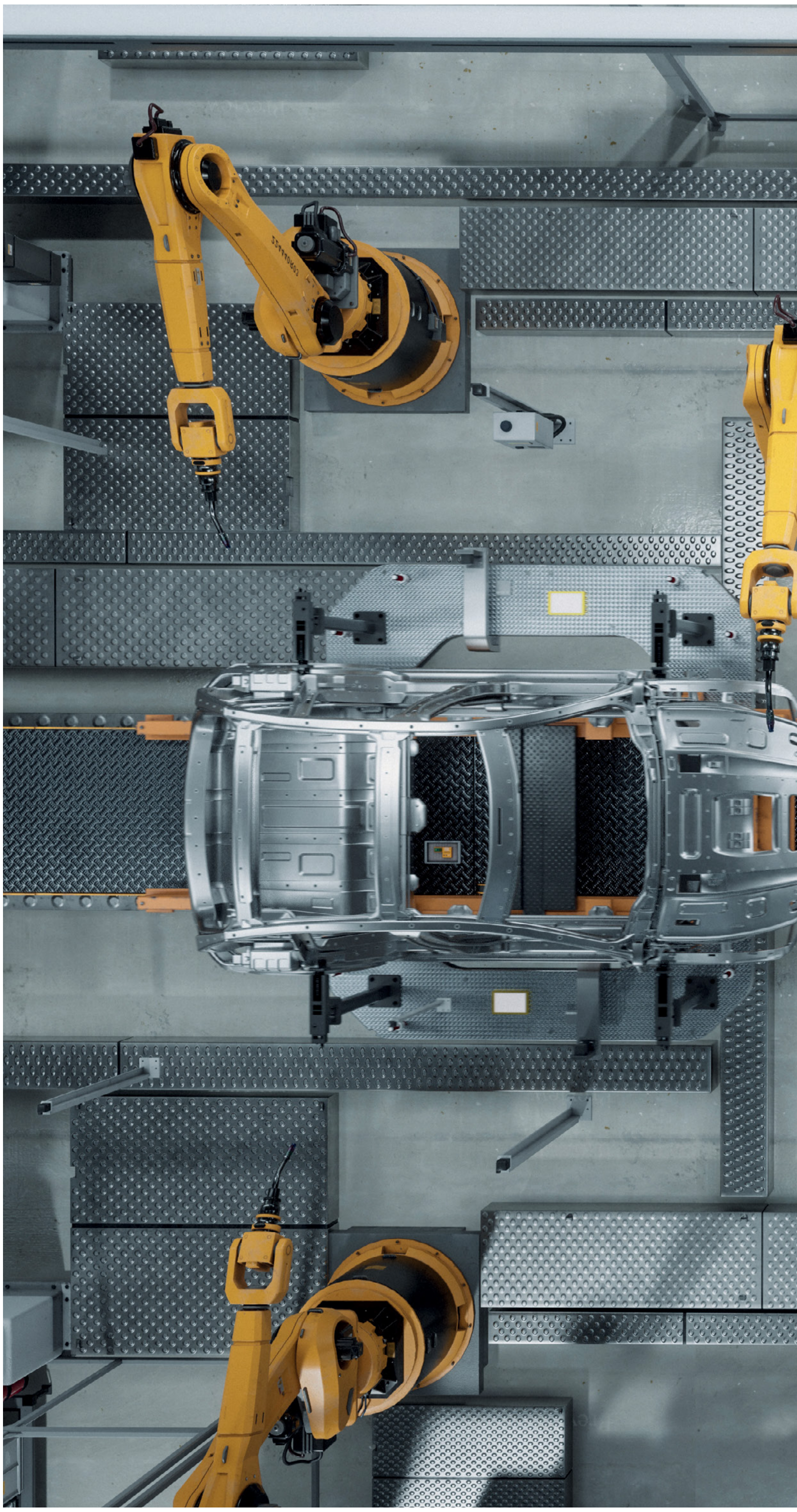
Secondly, most D&O policies treat M&A activity (above variable size and materiality thresholds) as a 'change in risk', with the result that cover for future wrongful acts after the effective transaction date automatically ceases. Expert advice is often needed to negotiate and secure appropriate ongoing cover for the directors for the merged or acquired entity.

Thirdly, no two D&O policies offer the same breadth of protection. For example, some expressly (albeit not always obviously in the policy exclusions section) exclude claims alleging either that the price paid for a corporate acquisition was too high or that a organisation allowed itself to be sold too cheaply. Others more straightforwardly either exclude or restrict cover for all M&A activity. Yet others may contain provisions restricting cover based on the capacity in which a director is sued or by diluting the overall limit of liability by allowing it to be shared with the corporate entity itself. Finally, some policies may simply not provide sufficiently good baseline D&O protection in line with current market standards.

9 Are there different governance considerations for public vs. private transactions?

Public company transactions typically have more stringent governance considerations owing to the listing rules that the transaction must comply with. The more rigorous regulatory environment in which public transactions take place means the governance structures of the target organisation and the transaction itself should be appropriately scrutinised by expert advisers before a transaction is consummated. The governance rules for private companies, and therefore private transactions, will vary significantly depending on the sector, size and jurisdictions in which the target operates.

Notwithstanding the applicability of listing rules to public transactions, governments are increasingly focused on protecting consumers, the environment and data privacy (to name just a few), which has led to increased regulations impacting large private, as well as public, companies. An ever-changing regulatory environment, targeted to enhance investor protection, accountability and transparency, means that it remains equally as important to ensure that any potential private acquisition targets are maintaining appropriate corporate governance structures and practices in compliance with the relevant laws and regulations.



"Divestment and separation due diligence is important. If your organisation is the seller, be prepared. Statements of value will be scrutinised and any hidden liabilities may be surfaced and introduce delays, weaken the confidence of a buyer and threaten financial plans and objectives. Ensure that enterprise-wide adequate separation plans have been prepared."

Julia Graham – CEO, Airmic

10 Do I have an understanding of the M&A insurance solutions available to cover unknown historical business risks associated with an acquisition and to ensure that the organisation can effectively limit its liability in the event of a sale?

The utilisation of Warranty & Indemnity (W&I) insurance (or representations and warranties insurance, as it known in North America) has become the norm on transactions in Europe and North America. A relatively young insurance product, the solution was born from sellers looking to divest themselves of historical and unknown liabilities associated with selling a business or asset.

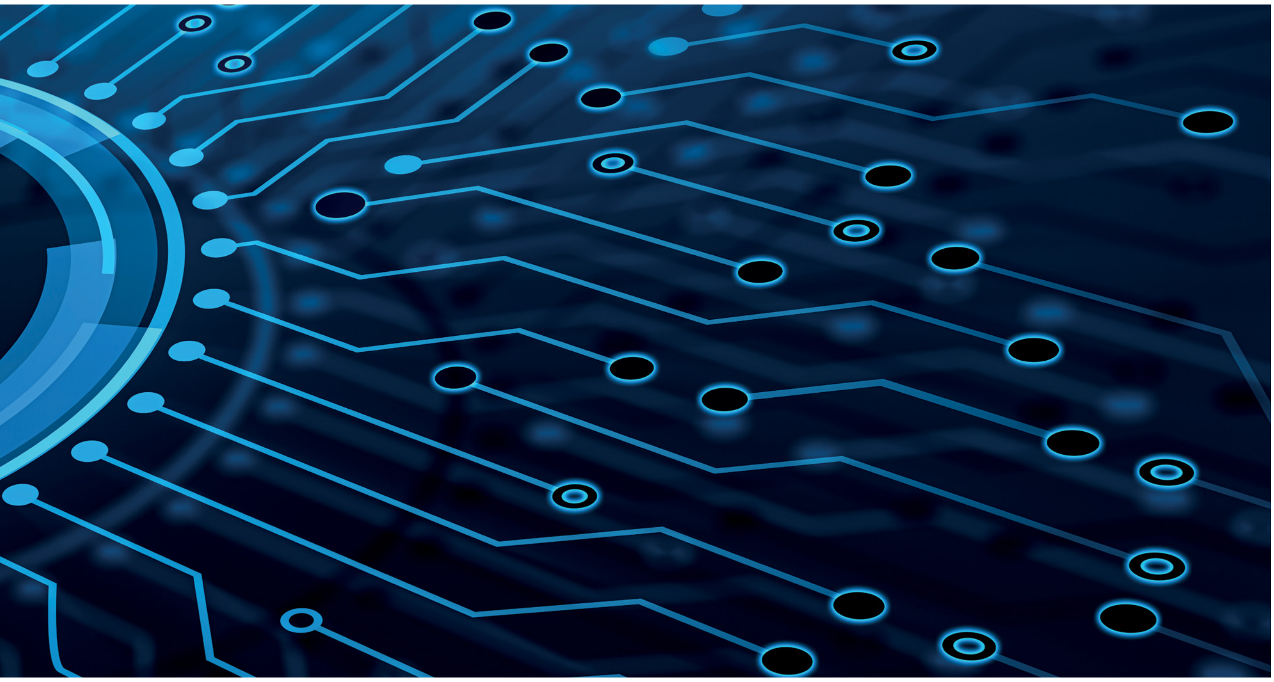
In an M&A transaction, sellers typically give buyers warranties or representations as to the state of the organisation or assets being acquired at the time the transaction is consummated. Post-acquisition, if the buyer suffers a financial loss as a result of a breach of one of those warranties, where the event giving rise to the loss occurred before the warranty was given, they would be entitled to recover such loss from the seller for breach of contract. W&I insurance provides a solution for buyers that steps in the shoes of the seller and allows the buyer to recover such losses arising from a breach of warranty from an A-rated insurer. This insurance solution also allows the seller to cap its liability for non-fraudulent breaches to a nominal amount, with the W&I insurance policy being the sole recourse for the buyer.

To retain control of the insurance process and to understand the scope of insurance cover available, sellers can instruct brokers to obtain preliminary, indicative terms from insurers, which are then presented to bidders with instructions to pursue the insurance independently – this is known as a 'soft staple'. Sellers also have the option to take the insurance process one step further and select an insurer on the sell-side and engage them to significantly advance the underwriting process using vendor due diligence (VDD). A negotiated policy for the benefit of the buyer is then presented in the data room, in a similar way to presenting VDD or fact books, materially reducing the time required for a bidder to finalise the W&I policy – this is known as a 'hard staple'.

11 Have I considered the cyber exposures associated with an acquisition, including the insurance solutions available to mitigate these risks?

The acquisition of a organisation can be accompanied by a number of 'unknowns'. Warranty & Indemnity (W&I) insurance may not sufficiently address all of these, including for example a cyber attack or data breach. These cyber risks can create substantial liability risks, such as increased scrutiny from regulatory bodies, and negatively impact valuation. Many cyber events are not immediately discovered, which means the impact may not be fully realised until after the transaction is complete. Cyber attacks have led to shareholder litigation, regulatory penalties and diluted value of companies. Preparation, access to specialist firms, assistance and funds following a cyber attack are critical elements.

Cyber insurance provides specialist cover for liability and first-party costs associated with cyber risks from both information and operational technologies. It operates on a modular basis, with coverage elements designed to help companies effectively manage a cyber attack and the resulting impact from discovery. Reference should be made to the second in our series of Boardroom Guides dedicated to this topic.



12 Am I aware of the M&A insurance solutions to ring-fence known legal and tax risks to ensure the organisation is not taking on any unwanted liabilities?

In addition to W&I insurance, which is designed to protect buyers from unknown risks (or seller fraud), Contingent Risk insurance and Tax insurance are solutions to insure known legal and tax risks identified either within or outside of a transaction context.

Tax insurance is a broad business solution rather than a narrow tax tool. It helps achieve business objectives by eliminating the residual risk that is inherent in sound tax advice. The solution provides financial protection against losses arising from identified the failure of a tax position to qualify for its intended tax treatment. Tax insurance is often sought in the M&A context (and may be obtained by buyer or seller) to facilitate the deal process by providing comfort that the parties are protected against any financial losses arising from identified tax risks. Insurable positions include historic tax risks identified as part of the due diligence process and carved out of a W&I policy, as well as tax consequences resulting from the deal structure. Accordingly, a Tax insurance policy helps eliminate the need for an escrow or indemnity to cover the tax issue, allowing for a smoother and more amicable negotiation process.

As an effective tool in managing balance sheet risks and liabilities, Tax insurance can also be utilised outside of a transactional setting to remove the uncertainty inherent in sophisticated tax planning (e.g. internal restructuring, integration, repatriation) and compliance, including to address tax matters currently under audit (i.e. positions that a tax authority is specifically examining or that are on a tax return that is subject to audit).

Similar to Tax insurance, Contingent Risk insurance provides financial protection against a known legal issue which may result in a financial loss. The insurance is a highly bespoke solution that can be used in a wide range of situations to isolate potential losses that may arise from known risks that are remote but could result in significant loss. Contingent Risk insurance can be used in many situations, including protection against missing beneficiaries emerging, contractual disputes, claimant-side and defendant-side litigation, intellectual property disputes or changes in law. It can also be used to release capital from balance sheets or avoid costly seller escrows/indemnities.

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