Contribution of Insurance in Facilitating Mergers and Acquisitions

Commentary and guidance on the role that can be played by insurance in support of successful Merger and Acquisition (M&A) activities

Produced for Airmic by Marsh’s Private Equity and M&A Practice
1. Contents of the Guidance

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2. Introduction to Mergers and Acquisitions (M&A)

3. M&A transactions and structures
   3.1 Target is a publicly traded company
   3.2 Share and asset structures
   3.3 Joint ventures
   3.4 Businesses in difficulty
   3.5 Cross-boarder activities
   3.6 Size of target and price paid
   3.7 Legal principles
   3.8 Parties at risk

4. Seller-side considerations
   4.1 Why companies sell parts of their business
   4.2 Structure of a typical sale process
   4.3 Guide to good preparation
   4.4 Apportioning contractual liability during a sale
   4.5 Transaction tools to mitigate contractual liability

5. Buyer-side considerations
   5.1 Why companies make acquisitions
   5.2 Structure of a typical buy process
   5.3 Addressing risk and insurance in M&A
   5.4 Factors behind success
   5.5 Apportioning contractual liability during a purchase
   5.6 Transaction tools to mitigate contractual liability

6. D&O insurance and raising capital

One of the main objectives of Airmic is to help Airmic members make a significant contribution to the success of their employer organisation. Airmic achieves this by running a series of seminars and training courses, as well as publishing guides to a wide range of risk management and insurance topics. In order to undertake these activities, Airmic depends heavily on partner organisations.

Airmic is grateful to Marsh’s Private Equity and M&A Practice for producing this guide to the contribution made by insurance to successful Merger and Acquisition (M&A) activities. The guide provides valuable insight for Airmic members into the contribution that their expertise can make in this important area of corporate activity.
2. Introduction to Mergers and Acquisitions (M&A)

Mergers and acquisitions (M&A) have long been a popular corporate strategy for non-organic growth and represent both challenges and opportunities in the global business environment.

This guide is an introduction to the M&A process, covering the period up to the date of the sale or acquisition, and discusses key points to note for risk managers and other executives involved in M&A strategy, from the disposal angle (seller side) and acquisition angle (buyer side).

Every M&A deal is different, but there are some common practices that can be used to lower the level of uncertainty and reduce the risk of surprises post-completion.

Insurance is one of many areas of consideration during the M&A process and throughout this guide, we look at ways that risk managers may be asked to help review and manage the risks from an insurance standpoint.

There are a variety of M&A transactions and structures and the most common are described in section 3. This guide focuses on private transactions where the buyer acquires the shares of the target being purchased.
3. M&A transactions and structures

Acquisitions are divided into ‘private’ and ‘public’ acquisitions, depending on whether the target is or is not listed on public stock markets. An additional dimension or categorisation is whether an acquisition is hostile or supported by the target company.

There are also a variety of structures used in securing control over the assets of a company, which have different insurance implications.

3.1 Target is a publicly traded company

If a bid is hostile, little or no due diligence information is likely to be provided to a bidder, which will instead have to rely on publicly available information, such as audited accounts and regulatory announcements.

If a bid is supported by the target company, certain limited due diligence information may be provided to a bidder to enable it to evaluate a target. The Takeovers Code, which governs takeovers of most UK publicly traded companies, requires the release of the same information that has been already provided to a rival bidder to any additional bona fide bidders who express an interest. Accordingly, it would be unusual for a target to agree to a complete release of all relevant information, even in supported bids.

In either case, it would be very unusual for a buyer to receive the benefit of warranty and indemnity protection from the sellers.

Sale and purchase agreements are not used / permissible in relation to a takeover bid for a UK publicly listed company’s shares.

Where the transaction is a sale of part of the business and/or assets of a publicly traded company, the Takeover Code usually does not apply and the sale process may be conducted in a similar fashion to a private sale, i.e. the seller (the listed company or a subsidiary) may give warranties, indemnities or undertakings in a sale and purchase agreement, together with certain pre-determined due diligence information (potentially to several bidding parties). Depending on the UK stock exchange on which the listed company’s shares are traded, such transactions may still be regulated by the UK Listing Authority’s Listing Rules or the AIM Rules for Companies, which may impose certain additional public disclosure requirements and other restrictions in relation to the disposal, e.g. shareholder approvals.

3.2 Share and asset structures

There are normally two different structures when selling a business and these are (1) to sell the company by selling its shares; or (2) for the company to sell the business and assets.

(1) Share transaction – For a buyer, acquiring shares means not only buying ownership of the business, but taking it together with all of the historic liabilities accrued by that business.

(2) Asset transaction – By only acquiring the business and assets from a company, a buyer can avoid taking most, but not all, liabilities. A buyer often structures a transaction as an asset purchase to “cherry-pick” the assets that it wants and leave out the assets and liabilities that it does not. This can be particularly important where foreseeable liabilities may include future, unquantified damage awards such as those that could arise from litigation over defective products or environmental damage.

One of the liabilities that a purchaser will generally be unable to avoid are accrued employee liabilities and terms of current contracts, which will come across under the Transfer of Undertakings (Protection of Employment) Regulations 2006 known as TUPE (or similar employment liabilities inherited under the European Union Acquired Rights Directive).
It is therefore important that employers know all about the employees they might inherit if they are looking to buy a business and that they are protected from or compensated for any employment liabilities that arose before they became the employer.

### 3.3 Joint ventures

Joint Ventures (JVs) provide different considerations to acquisitions, depending on their objectives and structure.

Many of the topics discussed in this guide will not, therefore, be relevant to the formation of a JV and the following are some examples of where attention may be required:

- Review of the formation agreement with respect to risk and insurance issues
- Review of JV partners’ insurance programmes (where appropriate)
- Review of JV partners’ current and historic insurance arrangements to understand what insurance may be available for any liabilities assumed by the JV.

### 3.4 Businesses in difficulty

The process for selling a business in difficulty is very different from a normal transaction. In most circumstances, the buyer spends considerable time and effort undertaking due diligence. With a business in difficulty, however, there is normally very little time for due diligence to take place and therefore the uncertainty over a distressed business’s real state is usually reflected in a very low price.

Most sales of distressed businesses are of the business and assets rather than of shares.

A “Pre-Pack Administration” is one where a sale of the business and assets has been arranged to a party that is able to then complete the transaction immediately upon the Administrator’s appointment. Insolvency provisions of the TUPE Regulations 2006 make insolvent employers more attractive by relieving them of onerous TUPE liabilities.

### 3.5 Cross-border transactions

The dynamics of cross-border M&As are largely similar to those of domestic M&As. However, due to their international nature, they also involve unique challenges, as differences in national cultures, practices and regulations can prevent companies from fully realising their strategic objectives. Deep knowledge of the local language, customs and legal requirements are important contributors to a successful deal.

### 3.6 Size of target and price paid

There is no correlation between the size of the target/price paid and the size, nature or complexity of the risk issues that may exist, and therefore spending less money does not mean that the extent and quality of the investigative work should be less.

### 3.7 Legal principles

In the UK, a contract to buy or sell a business is based on the principle of *caveat emptor*, ‘let the buyer beware’, compared with insurance contracts, which are contracts of ‘utmost good faith’.

Under the doctrine of *caveat emptor*, it is the buyer’s responsibility to ensure that what they are buying exists and that it is worth the asking price. The ways in which the buyer gets comfortable with what it is buying are outlined later in this guide. Comfort can be gained from undertaking due diligence and/or asking for contractual comfort from the seller in the form of warranties.
3.8 Parties at risk

Although the onus is on the buyer to carry out an examination of the target, both buyers and sellers are at risk of not creating value in the acquisition or disposal. The main factors behind lack of success are discussed later in the guide and include:

Sellers

• Purchase price disputes
• Post-deal completion issues, especially warranty and indemnity claims

Buyers

• Overpayment
• Post-deal completion issues, for example, losses arising from uninsured legacy liabilities
• Failure to integrate the target smoothly and efficiently.
4. Seller-side considerations

4.1 Why companies sell parts of their business

Some of the key reasons that a company may decide to sell a part of its business are:

- Raising capital
- Exiting a particular sector
- Exiting a particular geography
- Competition authorities forcing sale
- Insufficient capital to drive growth.

The sale proceeds received are often required to either pay off the seller’s debts or are allocated to more positive projects, such as expanding the remaining business organically or by acquisition of another company. However, the proceeds having been allocated, it is important they can be utilised as quickly as possible. Later in the guide, we will introduce some of the contractual comforts that a seller may give the buyer during the sale process, such as warranties or indemnities. If these are given, they will become contingent liabilities against the seller and the seller will not know until events unfold whether they will crystallise and whether they will need to make a post-completion payment to the buyer. The longer the sale proceeds are effectively ‘tied-up’ in the underlying M&A process, the company is effectively restricted from gaining the maximum benefit from the deal.

4.2 Structure of a typical sales process

The process that a company undertakes when selling another will largely depend on whether they have been ‘approached’ by an interested buyer and are just dealing with one party, or whether they have made a strategic decision to sell all or part of their company and use a corporate finance house to run an auction process, enabling competing bids from different buyers.

If the process is being run as a competitive auction, the seller will typically provide a pre-determined set of information to all parties that allows the due diligence process to move forward.

Technology, in the form of the online virtual data room (VDR) has emerged as a solution to optimise the due diligence process by overcoming the limitations inherent in traditional paper-based data environments.

Information is sometimes partly provided in the form of a report (vendor due diligence report). A vendor due diligence report will reflect the client’s strategic objectives, which are discussed with management before and during the preparation of the report and aim to address the concerns and issues that may be relevant to even the most demanding buyer.

Typically, the following due diligence reports may be produced:

- Legal due diligence – concentrates on the legal issues at the target such as contracts, employees, property, intellectual property, etc.
- Financial due diligence – concentrates on the accounting and taxation issues at the target company.
- Environmental due diligence – typically produced where the target has a number of sites, it focuses on any environmental regulatory or contamination issues.
- Commercial due diligence – looks at the sector in which the target operates, such as customers, competitors, etc.
- Insurance due diligence – looks at the target insurable risks and liabilities and the available insurance assets to cover these.
4.3 Guide to good preparation

To maximise the value of a disposal, it is important to mitigate or remove (1) issues that buyers could use to negotiate price; (2) post-completion value leakage arising from retained liabilities; and (3) unforeseen warranty or indemnity claims.

Research has shown that early planning and preparation provides the greatest opportunity to enhance a seller’s ability to extract maximum value from disposals and reduce the erosion of value, post-completion.

Minimising disturbance to the business being sold is also a key factor for a successful disposal, and good planning and preparation can limit the level of disruption of the day-to-day operation of the business.

To enable buyers to bid with confidence, they need to be in possession of the information necessary, maximising the value that they get from the disposal.

As buyers are conducting more detailed due diligence, if they “discover” issues on their own, it can cause them to wonder what else they may have missed in their due diligence.

Unexpected findings can result in purchase price disputes or even cause the process to stall or terminate, and therefore carrying out preparatory work at an early stage in the process gives the seller more time to develop potential upsides, but also address any downside issues in advance of the transaction. Put another way, it is much better to address any gaps or issues before going through the sales process than to have something come up at the eleventh hour.

Good preparation should include:

• Identifying potential transaction issues – Early identification will provide more time for a seller to develop potential upsides but also to address any downside issues in advance of the transaction.

• Anticipate buyers’ areas of concern, for example, the level of access that the disposed entity will have to its former parent’s insurance assets post-separation for assumed liabilities.

• Considering the best strategy in respect of outstanding and incurred but not reported losses.

• Deciding what information to provide to potential buyers and ensuring that it is consistent and robust. This would include the information provided to a data room. Typically, this would include details of the current insurance arrangements, specific information about the insurable risk exposures and claims experience of the target.

• Ensuring the sale and purchase agreement is tightly drafted.

• Identifying any separation costs on the retained business.

This will help to:

• Maximise the value of bids (by reducing or removing issues that provide buyers with ammunition for price reductions or the ability to walk away from a deal)

• Increase the speed of a sale

• Reduce management time and disruption to the seller and business being sold

• Reduce the erosion of value post-completion as informed decisions will have been made regarding the sale of the asset

• Manage shareholder expectations.
4.4 Apportioning contractual liability during a sale

The due diligence process undertaken by buyers is part of the way that the buyer finds out information from the seller. This ensures that the buyer knows as much as possible about what it is buying as it will inherit the liabilities as well as the assets of the company.

Another way that the buyer gets comfortable is through obtaining (1) warranties; (2) a tax covenant; (3); indemnities; and (4) disclosures from the seller.

(1) Warranties

Warranties are effectively contractual promises given by the seller (or its management team) in relation to a huge raft of matters at the target such as:

- Title to the shares being sold
- Group structure
- Employees
- Property
- Intellectual property
- Contracts
- Litigation
- Taxation,

(2) Disclosures

As well as providing warranties, the seller will undertake a disclosure process against those warranties to extract any information that contradicts the warranties. If a warranty proves incorrect post-sale and there has been no disclosure against it highlighting this, then the buyer may be able to sue the seller for breach of warranty. It is typical in the UK that warranties are given by the seller for up to seven years for taxation and between one and three years for non-taxation warranties. Having this contingent exposure for such a long period can create a level of uncertainty for the selling company and prevent the unencumbered use of sale proceeds.

(3) Tax covenant

In the UK, in addition to warranties it is typical that the seller will also give an indemnity (in the form of a tax covenant in the share purchase agreement or in a separate agreement known as a tax deed) to the buyer stating that it will be liable (following closing) on a pound-for-pound basis for any tax exposures of the target arising in relation to events or time periods occurring prior to closing. Depending on the circumstances, these indemnities may be subject to certain limitations, e.g. the seller will only pay for tax that:

- exceeds any provision made in the target’s accounts for the period up to the last accounts date;
- or
- has arisen since the last account’s date for matters outside the ordinary course of business.

A breach of warranty claim is calculated by reference to the reduction in the value of the shares of the target, whereas the tax covenant gives the buyer the right to claim that the seller makes good their loss on a £-for-£ basis. With a call under the tax covenant the buyer does not have a duty to mitigate loss and
its ability to recover will not be limited by any disclosed matters; this is unlike the position for a breach of warranty claim.

(4) Indemnities

If any specific points of contention arise during the due diligence process, the seller may be asked to give a specific indemnity to the buyer as regards the issue. Similarly to a call under the tax covenant, a breach of a specific indemnity has the benefit over a breach of warranty claim in that it gives the buyer the right to claim that the seller makes good its loss on a £-for-£ basis. There is no duty to mitigate loss, and recoverability is not limited by any disclosed matters. Therefore, sellers are often more reluctant to give a specific indemnity than they are a suite of warranties.

4.5 Using transaction tools to mitigate contractual liability

Transaction tools have been developed to bring a level of certainty for one or both parties should there be a breach of warranty or call under the tax covenant. One of the most common is an escrow whereby a specified sum of money is held by an independent third party. One of the most common triggers for the release of the monies to the buyer is if there is a proven breach of warranty claim or call under the tax covenant. Whilst this can prove attractive for a buyer, it is often resisted by sellers as effectively a portion of the sale proceeds is held back from them, which prevents them from being able to use the sale proceeds to pay off debt or make a new investment. In addition, buyers often view the escrow proceeds as ‘fair game’, in particular if the transaction has not been a complete success for them.

The insurance market has also developed a suite of solutions to bring certainty to the parties. One of these is warranty and indemnity insurance (W&I insurance) which aims to provide cover for unknown breach of warranty claims or calls under the tax covenant. It can be utilised by the sellers when they are happy with giving warranties to the buyer up to an agreed cap on liability but wish to insure away this potential liability (see diagrams 1 and 2); this is known as a seller-side policy. Alternatively, it can also be utilised by the buyer typically where the cap on liability offered by the sellers is low and for them inadequate (see diagrams 3 and 4); this is known as a buyer-side policy. Having the knowledge that a third-party insurer is on risk in the event of a breach of warranty claim can enable the seller to utilise the sale proceeds immediately without waiting for the warranty periods to expire.

Increasingly, sellers are being proactive in their use of W&I insurance and are introducing the concept of a buyer-side policy to bidders in an auction process. When the data room of information is prepared by the sellers and a first draft of the contract for sale (often called a Share Purchase Agreement or SPA) is put in, a note for bidders is placed alongside this stating that their broker has begun the process of arranging W&I insurance for the buyer. The seller’s broker will then discuss the process and policy coverage with the bidders and the engagement will then transfer from the seller to the preferred bidder as the policy will be for the latter. This structure has the advantage over a seller policy for the sellers in that the sellers’ liability will be capped at a low amount, typically 1 per cent of the transaction value but may be lower. Over and above this, they have no liability bar in the event of fraud.
Diagrams 1 and 2: Seller-side policy

Transaction value: £100m
Seller warranty cap: £80m
Excess under W&I insurance policy: £1m
Seller-side W&I insurance limit: £79m

Share purchase agreement (SPA) position

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<thead>
<tr>
<th></th>
<th>Buyer’s liability</th>
<th>£100m</th>
<th>Seller’s liability</th>
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<tr>
<td>Claims threshold in SPA</td>
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<td>Seller-side W&amp;I policy</td>
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<td>Seller’s liability</td>
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Diagrams 3 and 4: Buyer-side policy

Transaction value: £100m
Seller warranty cap: £1m
Excess under W&I insurance policy: £1m
Buyer-side W&I policy limit: £79m

Share purchase agreement (SPA) position

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Position with Seller-side W&I insurance

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Whilst W&I insurance is intended to cover unidentified breaches of warranty or calls under the tax covenant, quite often during due diligence, an identified matter comes to light which causes the buyer the most concern. This could be related to an issue such as a piece of pending litigation or a potential tax exposure. Sellers may be asked to give a specific indemnity as regards the issue, but as alluded to previously, may be reluctant to do this. Insurance can often be used to ring-fence an identified issue and effectively remove it as a point of contention from the transaction process. This could enable a seller to exit the transaction without giving an indemnity.

In an M&A transaction, there is often a trade-off between the maximum sale price that can be achieved versus the level of contingent liability that the seller is asked to give in relation to warranty and indemnity claims. A bidder willing to pay £100m for a target, but requiring a seller to give warranties and specific indemnities up to this amount, may be less attractive than one willing to pay a little less but requiring a lower cap on exposure. It is, therefore, wise to consider the sale price in conjunction with the contractual term of any warranties or indemnities provided.
5. Buyer-side considerations

5.1 Why companies make acquisitions

There are many different reasons why companies make acquisitions, but the main rationale is for improved financial performance. A successful deal maximises shareholder value and the quality of due diligence that is undertaken before a deal completes and the post-acquisition integration strategy are key factors to achieving success.

5.2 Structure of a typical buy process

In the early stages of the due diligence process, it is not unusual for information that is made available to all bidding parties to be limited, with more detailed and proprietary information being reserved for more serious contenders or the final buyer.

During the due diligence and negotiation period, the process will move forward and the buyer requests and receives information (Q&A session).

The level of due diligence a buyer undertakes will largely be motivated by how familiar they are with the jurisdiction of the target, size and sector, and any significant underlying issues that they are aware of or concerned about.

One of the important factors for a buyer to consider is the level of materiality that is set. This needs to be at a level that enables the buyer to undertake a thorough review whilst not inundating the seller with a lot of trivial questions. If the buying is relying on a vendor due diligence report, the level of materiality set by the seller when producing the report should also be established.

5.3 Addressing risk and insurance in M&A

M&A presents two major challenges from a risk and insurance standpoint: (1) properly addressing the target’s pre-close legacy liabilities; and (2) managing future risks (i.e. determining the optimum structure and integration of the programmes post-completion). Addressing these challenges all starts with understanding the target’s risk profile, total cost of risk, legacy liabilities and historical insurance assets.

5.4 Factors behind success

Buyers need to evaluate a target company to support its value and find out whether there are ‘skeletons in the cupboard’. This will include issues that impact both deal negotiations and the financial success of a transaction, including issues that require reflection in the SPA.

The findings of insurance reviews are rarely ‘deal breakers’ and may not materially affect the purchase price of the target. However, the information provided often affects how the SPA is drafted and provides a truer picture of the value of the liabilities and assets to be acquired. This includes the cost of any ‘corrective insurances’ to bridge gaps, which can be costly. Failing to scrutinise the seller’s risk and insurance programme and the SPA can impact the value obtained from an acquisition.

Underestimating or failing to address insurance-related issues, such as understanding how pre-close legacy liabilities will be treated and ensuring risk management budgets are not underestimated, can have a material impact on the transaction and the ability to realise the full value of the deal, leaving companies exposed to potentially large hidden costs and unexpected liabilities.

Typical issues include:

• Changes in the insurance budget – The cost to insure or to fund risks can make up a large amount of a target’s income statement or balance sheet. Insurance policies and good risk management practices should be seen as assets of the target, protecting both the balance sheet and the income statement, and the liquidity profile of the target.
• Protection from unexpected outcomes post-completion – Whether a seller’s pre-transaction insurance policies will protect the buyer against post-transaction liabilities will depend upon several factors, including quality of coverage afforded, applicable law, specific policy language and the terms of the deal. For example, many policies contain provisions that can hamper a buyer’s ability to access policies in times of need. Finite policy limits may have been impaired by other claims, or other parties may seek coverage under the same insurance policies.

• Inadequate or no provisions for self-funded losses.

• Known litigation and environmental matters.

• Ambiguities in the sale and purchase agreement – Indemnities, warranties and disclosures relating to risk and insurance, the way that historic liabilities will be dealt with / funded going forward, and other insurance-related matters such as access to historic policies are often ambiguous or silent.

• In respect of any direct captive involvement:
  • The desire of the captive going forward to meet ‘past’ liability claims
  • Financial security of the captive going forward and its ability to continue to meet ‘past’ liability claims.

In addition, reviewing and understanding the change in control provisions of claims-made policies (e.g. Directors’ & Officers’ Liability insurance) and developing pricing recommendations for required extended reporting periods will require attention in all M&A transactions.

Understanding these issues and the impact that they have can mean the difference between:

• A more efficient price versus overpayment or post-close surprises
• Improved sale and purchase agreements versus having ambiguities in the purchase and sale agreement
• Smoother, faster integration versus delays and unrealised synergies, and
• Improved corporate governance.

Depending on the transaction, the key areas that need to be looked at are:

• What insurance does the target currently buy?
• At completion of the transaction, will the policies be able to continue in force for the benefit of the target or will the policies automatically expire or cease to provide cover?
• What are the key risk exposures and to what extent does current/historic insurance address them? If not at all (or only partly), what solutions are available to fix it and what will it cost?
• Are there any uninsured exposures that could give rise to a liability after completion (including legacy liabilities from historic M&A activity)?
• How much does the current insurance cost?
• What is the ‘right’ insurance programme to have after the deal completes and how much will this cost?
• What is the difference between the current and future costs?
• What insurance-related issues need to be included in the sale and purchase agreement?
Note that this is not an exhaustive list but provided as a guide only.

A review should also identify additional cost issues that could lead to one-off additional risk and insurance-related costs, which can be used to negotiate one-off reductions to the purchase price. They include:

- The price of any risk improvements required by insurers
- The cost of retrospective premium adjustments
- The cost of self-insured losses (losses below deductibles for incurred losses, reported or otherwise), including those unsettled by insurers (outstanding claims) and losses for which insurance has not been purchased
- The cost of administering legacy liabilities
- The cost of insurance to cover any capital expenditure projects (e.g. CAR insurance for the construction of a new building)
- Any other one-off items requiring an insurance solution or other ‘fix’, for example, the purchase of Directors’ and Officers’ Liability (D&O) run-off cover.

Post-acquisition integration issues need to be considered at the beginning of a deal, and undertaking a risk and insurance review pre-acquisition will also form the basis for planning the integration and identifying / implementing synergies, enabling faster and smoother integration.

Providing a “road-map” of what the on-going insurance programme should look like should include:

- Determining the structure of the insurance programme post-completion with consideration of the insurance regulatory and premium-related tax implications, and compliance with compulsory insurance requirements.
- Recommendations for future programme limits, deductibles terms of cover, etc.
- Recommendations for future risk improvements to reduce on-going claims or other risk-related drains on capital
- Protection against any unexpected expenditure after the deal is done.

5.5 Apportioning contractual liability during a purchase

The ‘caveat emptor’ approach is one that is not often relied upon by sophisticated buyers as it is typical to seek warranties and to encourage the seller to perform an extensive disclosure process to ‘flush out’ any issues. The disclosure process helps a buyer assess a particular transaction so that it can make a commercial decision to:

- Adjust the purchase price to take account of matters discovered
- Seek additional contractual comfort in the form of a specific indemnity
- Withdraw from the transaction.

The corporate structure of the seller can have an impact on the buyer’s approach to a transaction. If buying from a private equity seller, the buyer’s ability to negotiate warranty caps may be limited. Private equity houses will want to distribute the profits of any sale of the target back to their investors (known as Limited Partners); therefore, they are typically reluctant to give any warranties or indemnities to the buyer. Often the target’s management will give warranties but will want to cap their liability at the portion of the sale proceeds that they personally receive, not the overall transaction value. This can mean that
there is a gap between the warranty cap requested by the buyer and the one the sellers are willing to give.

Corporate sellers do not have the same pressures as a private equity house, so can be more willing to give warranties or indemnities to the buyer. However, many corporates have seen private equity houses exit transactions with no warranty exposure and wish to emulate this.

Another factor that will affect the contractual apportionment is the financial health of the seller. If the seller is in financial distress, it may offer the buyer a commercial level of warranty comfort to induce a quick sale. However, the buyer may query the strength of financial covenant standing behind the warranties. W&I insurance can be utilised by the buyer to sit in parallel with the seller’s warranty cap should the seller be unable to pay a warranty claim.

5.6 Transaction tools to mitigate contractual liability

An escrow can be attractive to a buyer when seeking secure recompense for breach of warranty claims as they benefit from funds being held in a third-party account. This largely takes away fears over the potential credit risk of a seller. However, from the buyer’s perspective, if they are bidding for a well-performing target in a competitive process, there is a balance between requiring sufficient recourse against the warranties and remaining competitive. Escrows, as highlighted before, can hinder the seller’s ability to utilise funds post-sale and therefore are often resisted by the seller.

Buyers can use W&I insurance strategically where they want to enhance their competitiveness but still require a certain percentage of the transaction value as recourse against the warranties. In a scenario where the seller offers a warranty cap that the buyer is comfortable with, instead of accepting it or asking for an escrow against it, they can suggest a lower cap and make up the shortfall by taking out a W&I insurance policy for the balance. This has the advantage of the buyer attaining the level of recourse required through a combination of seller and third-party insurer recourse (see diagrams 5 and 6).

The same analogy can be made if a specific issue arises whereby the knee-jerk reaction of a buyer is to ask for a specific indemnity. Again, if the buyer is trying to remain competitive, it might want to look at alternative methods of attaining comfort perhaps via an insurance policy to ring-fence the specific issue.

Diagrams 5 and 6: Using buyer-side W&I insurance strategically

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<thead>
<tr>
<th>Transaction value: £100m</th>
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<tr>
<td>Seller warranty cap: £25m</td>
<td>Seller warranty cap: £1m</td>
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<tr>
<td>Buyer-side W&amp;I policy: £24m</td>
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**Position: accept seller offer of £25m cap**

- **Buyer’s liability**: £100m
- **Seller’s liability**: £25m

**Position: reject seller offer: use buyer-side policy strategically**

- **Buyer’s liability**: £100m
  - **Buyer-side W&I policy**: £25m
  - **Seller’s liability**: £1m
6. D&O Insurance and Capital Raising

When seeking to raise funds through offering securities to the public or seeking admission to trade on a public exchange, a prospectus or listing particulars will be issued. This document is extensive and will include detailed financial information on the company as well as projections and future strategies.

Signatories of a public prospectus for an equity offering have a personal responsibility for its contents. Liabilities may arise if the prospectus contains any reservations or misrepresentations, which investors rely on when deciding to invest.

The Directors’ and Officers’ Liability (D&O) Insurance policy may be affected by raising funds in this way. The following factors should be considered:

• In the majority of cases, US equity-raising activities of any significant nature would be automatically excluded from the D&O policy coverage. For non-US raisings, it is policy dependent, with some policies containing provisions that would automatically exclude coverage for any actions based upon arising out of or attributable to a mid-term equity capital raising. It is also not unusual for other policies to broaden this exclusion to take away coverage for debt offerings also.

• If the D&O policy does not contain an exclusion relating to capital raising, then there are other considerations, for example:
  • The insurer may look to adjust renewal terms and incorporate a price increase to cater for the coverage that had been automatically afforded.
  • If coverage has not been explicitly referenced or discussed with insurers, it may cause concern to the individuals who are personally exposed.
  • Often an offering of this type will have been under discussion for some time and (assuming the current policy is placed under UK Law) the disclosure obligations to insurers may come into question in a claims scenario.

An alternative to extending coverage under a D&O policy is to consider a Public Offering of Securities Insurance (POSI) policy. The key benefits of a POSI policy instead of relying on the D&O policy are as follows:

• A POSI policy is specifically designed to cover the increased liability of the capital raising and, as such, is designed to cover the entire period (six years) whereas a D&O policy is an annually renewable policy (where cover could be denied for subsequent years).

• The POSI policy is designed to cover the “transaction” leaving the D&O policy to deal with the day-to-day business.

• The POSI policy is designed to cover the specific liability that is expected as a result of the transaction, whereas the D&O policy is not.

• A D&O policy may be affected by the issue in any event and, as such, there may be costs associated with a renewal where underwriters perceive that the transaction increases their liability at renewal.
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