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GUIDE 2020

Risk & Insurance in Mergers & Acquisitions

IN ASSOCIATION WITH:

AON

Acknowledgements

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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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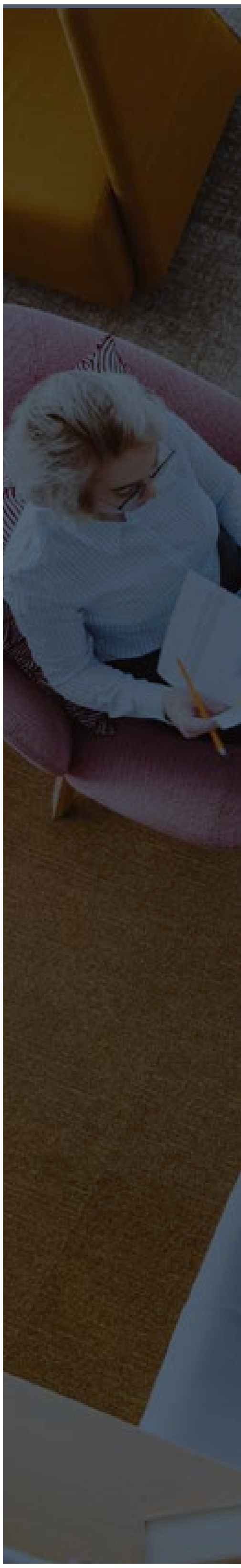
01 Introduction

This document provides guidance on the types of deals companies undertake and outlines key risk, insurance and human capital considerations, together with the insurance solutions that are available to support a transaction.



In the UK, a contract to buy or sell a business is based on the principle of 'caveat emptor', known as 'let the buyer beware'. This means that it is the buyer's responsibility to be comfortable with what they are buying. The deal negotiations and information-gathering part of the M&A process are very important to both the buyer and the seller and can help to avoid future value reductions in the acquired business.

Due diligence can help in making informed decisions regarding exposures attaching to a target business and assists a buyer in incorporating any unexpected costs into the deal. Further, it helps ensure that key risks are identified and understood as these can often have a direct impact on revenue.

Where the acquisition involves the acceptance of past liabilities, the quality of the target company's historic insurance policies can be as valuable as its physical assets or market share.

In addition, transaction risk insurance solutions can be used to enhance the position of the buyer or seller or used to overcome potential issues within the deal negotiations. Transaction risk insurance solutions include warranty and indemnity (W&I) insurance, tax liability insurance, contingent risk insurance, title insurance and environmental risk insurance.

For sellers, transaction risk insurance solutions can be used to enhance the exit value and, for buyers, they can provide additional financial comfort or a method for them to remove a tricky deal issue from the negotiating-table.

This document reflects insurance and legal practice in the United Kingdom, although many of the principles will apply to other territories. This document does not constitute legal advice and members should refer to their advisors on all aspects of this guide.

01 INTRODUCTION

02 The different types of transactions

Transactions are either 'private' or 'public', depending on whether or not the target is listed on a public stock market.

An interest in a business can be sold or acquired in several ways:

- By making a successful bid for the shares of a publicly traded company (a public deal)
- By selling/buying shares of a private company (a share sale)
- By selling/buying the assets of a company, for example a building or piece of machinery (an asset sale)
- By selling/buying shares through the offering of securities on a stock exchange (initial public offering (IPO))

There are significant differences in how due diligence and transaction risk insurance solutions can be used depending on the type of sale/ purchase.

Acquiring shares in a company usually means buying the business including the historic liabilities accrued by that business. Such historic liabilities can include, for example, tax, defective product or environmental liability. With an asset sale/purchase, a buyer can usually avoid acquiring most, but not all, liabilities.

2.1
Acquisition via public share deals

To acquire a public company, the potential purchaser has to make an offer to the shareholders of the company for their shares. The acquisition is successful if the majority of the shareholders agree to accept the share offer.

With these deals, in many cases, the bid is supported by the target business and information is provided on the target company. However, the target company will limit the information provided, usually because it does not want to release confidential information to a competitor or because it is under regulatory obligations to ensure the equal provision of information to all parties.

For public bids that are hostile, there is little, or no information provided to a bidder in the initial stages. The buyer will have to rely on its own research and publicly available information, for example, audited accounts and public announcements.

UK publicly traded companies are subject to the City Code on Takeovers and Mergers and the EU Takeovers Directive (2004/25/EC, given statutory basis via The Companies Act 2006). These regulations are designed to ensure fairness to shareholders and bidders; for example, all bidders must be provided with the same information.

Due diligence in public offers is usually restricted compared to private sales and there is a limited opportunity to utilise other insurance-backed deal solutions.

2.2
Acquisition via the purchase of private shares

With the share sale of a private company, the buyer acquires the shares in the company under a sale and purchase agreement and takes on the company, generally, with all historic liabilities and obligations. Most sellers agree to give warranties, indemnities or undertakings in a sale and purchase agreement relating to the historical activities, liabilities and obligations of the target company.

With this type of sale, only the shares in the company are transferred to another party and all assets and liabilities remain with the target company (as with public share deals). Customers and suppliers are usually happy to continue dealing with the company as before. With a share sale, there is usually no change of employer and the employees simply remain employed by the target company.

When a change in the ownership of a company is planned, certain contracts, including some insurance policies, may specifically require various third-party consents to enable these contracts to continue. A change in control may trigger other changes to existing contracts.

We outline in later sections how insurance solutions can assist in private share sales.

2.3
Acquisition via a public-to-private transaction

A public-to-private transaction is a kind of hybrid combination of the above and refers to a transaction or series of transactions that convert a publicly traded company into a private entity, generally involving a bid for a listed company made by a newly incorporated unlisted company (meaning that, thereafter, the target company's shareholders are no longer able to trade their shares in the open market).

It is in certain circumstances possible to utilise transaction liability insurance products to support such transactions.

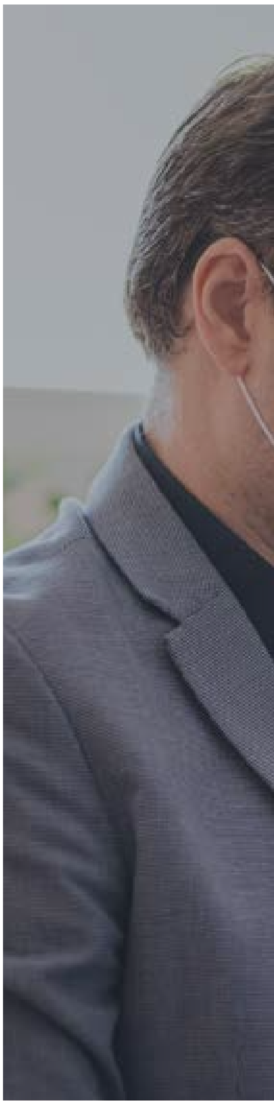
2.4
Acquisition via the purchase of assets

With an asset sale (by a private or public company), the buyer only acquires the actual assets detailed in the sale agreement.

With these transactions the seller may agree to give some limited warranties in the sale agreement relating to the assets being sold.

For the most part, the past liabilities and obligations of the business remain with the selling company. However, even in an asset sale, a buyer will generally be unable to avoid accrued employee liabilities and maintaining the terms of current employment contracts, as the transaction will usually fall within the Transfer of Undertakings (Protection of Employment) Regulations 2006, known as TUPE. It is important to obtain legal advice on whether or not the transaction falls within TUPE.

Due diligence therefore needs to include information on the employees the buyer might inherit. Buyers



should ensure that they are aware of any employment liabilities (and their potential costs) that arose before they become the employer. It may be possible to seek indemnities for such costs or for the purchase price to be reduced to compensate the buyer.

Buyers and sellers should be aware for such asset sales that they will have specific obligations to inform employees about their plans and may need to consult with employees prior to completion of the sale. Certain pension rights may also transfer to the buyer by virtue of the TUPE regulations.

Liabilities, arising from environmental issues, may be assumed by the buyer and should be clarified.

As with private share deals, we outline later how insurance solutions can assist with these types of deals.

2.5
Acquisition of distressed businesses

A distressed business is either a company that cannot service its current debt or a company that has entered into administration/insolvency. Most sales of distressed businesses are of the business and assets rather than of shares in the company.

The acquisition of the business and assets of distressed companies from an administrator (or liquidator) allows buyers to avoid acquiring many of the usual historical liabilities attaching to such companies.

For example, the insolvency provisions of TUPE may allow buyers to avoid acquiring TUPE liabilities. However, this may not be the case for 'pre-pack administration' (i.e. a sale of the business and assets arranged before the company enters administration). Specific legal advice should be sought.

Most sales of distressed companies need to be completed promptly which means that all due diligence has to be undertaken very quickly and so is often limited. Issues include:

- lack of information
- deliberate underinsurance/reduced limits/ covers not bought
- risk management action points required by insurers not completed

Whilst a sale and purchase agreement will generally be used, an administrator will not provide any warranties or indemnities about the business. In addition, if a company is in administration, existing insurance policies may not survive the sale.

As detailed above, due diligence is very restricted and there is a limited opportunity to utilise insurance solutions.

That said, there has recently been an increased focus (in the absence of warranties provided by the seller) on the possibility of the insurer drafting the

warranties itself (referred to as it providing them on a “synthetic” basis) which it may then insure for the benefit of the buyer.

2.6

Initial public offering of securities (IPOs)

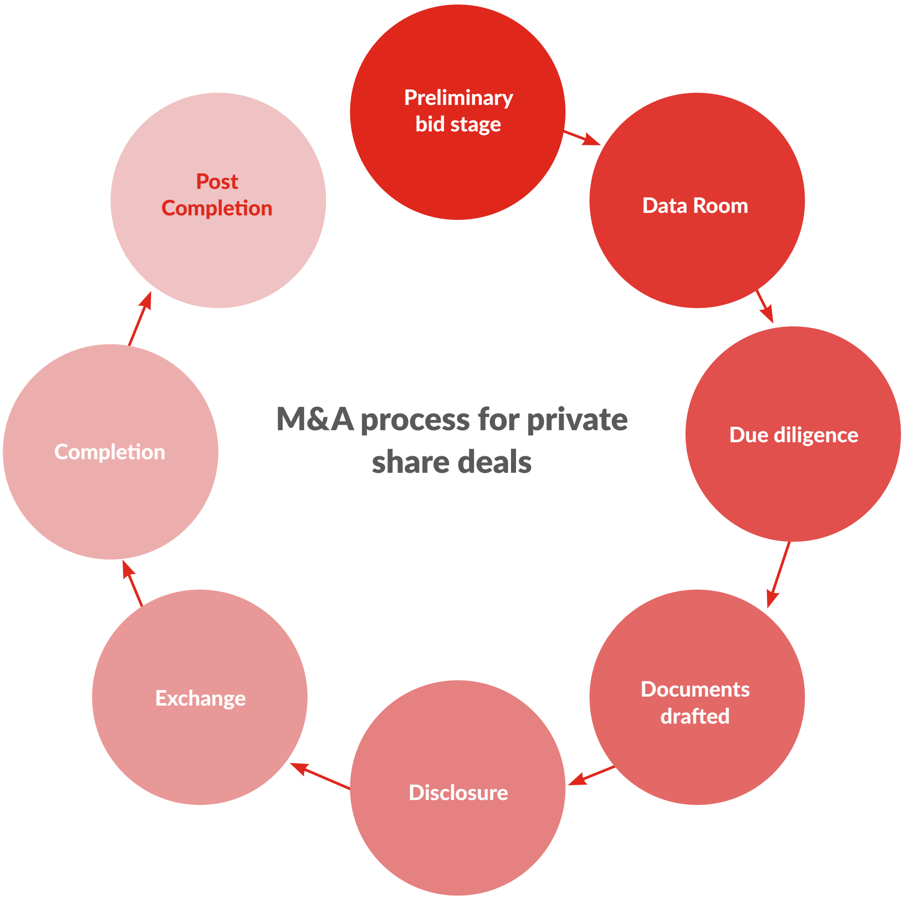
A company may look to raise funds or shareholders may wish to exit through the offering of securities on a public exchange.

For this type of transaction, the company will need to issue a prospectus document or listing particulars. Prospective shareholders will rely on this information and the document will include detailed financial information on the company, projections of future income and details of proposed strategies.

The signatories of a prospectus or listing particulars have personal responsibility for its contents; this risk in particular falls on the shoulders of the company’s directors and officers. There are insurance solutions that can assist with these additional liabilities.

03 Transaction process for private share deals

The most common type of transaction is the sale and purchase of shares in a private company. The following section sets out the usual steps that are undertaken in this type of deal.



The transaction process will differ slightly depending on whether the seller has been 'approached' by one interested buyer or if it has chosen to sell and is running a sale process for a number of buyers (an auction).

3.1
Preliminary bid stage

Ideally, sellers will prepare for a sale to maximise the price achieved and ensure that the deal does not hit any unexpected problems. Sellers will want to identify any issues that will cause concern to the buyer, or perhaps reduce the price or leave them with retained liabilities (for example, environmental issues) post close.

If the sale involves a competitive auction, the seller will typically provide a predetermined set of information to all parties that allows the bidder due diligence process to move forward (usually via a virtual data room (VDR)). Some sellers will provide vendor due diligence (VDD) reports on a variety of key areas, including insurance. The sellers will negotiate and sign up to heads of terms, confidentiality and exclusivity agreements with bidders where applicable.

3.2
Data room

Most deals involve the establishment of a data room. A data room is usually a virtual space where the seller can disclose confidential information in a controlled manner to a number of other interested parties. Information will typically include documents relating to corporate, legal, contractual, financial, property, employee, insurance, and environmental matters.

3.3
Due diligence

A buyer will want to gather as much information about the company or business as possible to understand what it is taking on – as a process, this is known as 'due diligence'.

Due diligence is typically a thorough appraisal of the condition of the company or business being acquired. This gathering and evaluation of information is carried out by the buyer's advisers and relevant people from within its own organisation.

Information obtained during due diligence feeds into the drafting of the deal documents and negotiations. The information obtained will help the buyer:

- evaluate what it is buying and identify any potential weaknesses
- understand the strength of its bargaining position – for example, is there a reduction in sales?
- identify any liabilities or risks that may affect how the deal is structured
- identify areas where warranties and indemnities need to be added into the sale/purchase agreement
- identify any third-party consents that may be required, for example, from landlords or lenders
- identify areas that may need action following the acquisition, for example, the relocation/consolidation of manufacturing overseas to maximise cost efficiencies
- decide whether to go ahead with the purchase
- establish the right price.

The following types of due diligence reports may be commissioned:

Table. Types of due diligence reports

Legal due diligence	Legal due diligence will focus on assessing the possible legal risks related to the transaction including in respect of the corporate status, assets, contracts, securities, intellectual property, litigation, and personnel attaching to the target company. Traditionally, the buyer's lawyers send a detailed information request to the seller or its lawyers. The extent of enquiries in any particular area will depend on the nature of the target business or company, the nature of the transaction, the reasons for the sale and what the buyer perceives as the risks. Some sellers, at the outset of the transaction, provide a vendor due diligence (VDD) report which includes the main issues that may be relevant to the buyer. The buyer's lawyers will evaluate the information provided and provide a report for the buyer which will highlight issues of concern and suggest protective measures where appropriate.
Financial due diligence	Financial due diligence will focus on assessing the historic trading performance of the company or business to check that the assumptions the buyer is making about its future are supported. The buyer's tax accountants will review the tax history of the target and focus on identifying any issues that could be disputed by HMRC.
Commercial due diligence	Commercial due diligence informs a buyer about the commercial and operational status of the target's business, products and/or services, typically, looking at its market, competitors, customers, proposition and future strategy.
Risk and insurance due diligence	Risk and insurance due diligence will identify the key risks faced by the target company or business and will assess how well they are managed including the extent to which insurance would respond to such exposures and how much self-insurance is carried by the target company. Additionally, sellers' insurance VDD reports should include information on the risk exposures (such as a risk register); current risk and insurance programme; costs of self-insurance; any collateral issues (e.g. letters of credit); and claims experience, including estimates for incurred but not reported losses. Some insurance VDD reports will also include an estimate of the cost of any future insurance programmes, especially where the transaction involves the sale of a subsidiary (spin-out).
Human capital due diligence	Human Capital due diligence informs the buyer of any employment related risks and liabilities at the target company. The review also seeks to determine any potential employment and employee benefit related issues and additional costs which could arise post completion. This due diligence covers many aspects such as executive compensation, reward, pensions, equity compensation plans, workforce profile and employee relations. (See section 5 for further information).
Cyber security due diligence	Cyber security and data protection due diligence is designed to identify cyber technical risks, financial exposure and compliance status, e.g. with GDPR, early in the transaction and, in tandem, provide transparency on future investment needs
Integrity due diligence	Integrity due diligence involves in-depth research into the standing of an M&A target to help determine potential damage to the brand or financial loss. These assessments involve reviews of public records, media publications, online sources and proprietary databases as well as law enforcement and regulator watch lists to uncover reports of reputational concerns or operational issues. Diligence is iterative and wide-ranging in nature, encompassing checks into not just the subject entity but also its management team, ultimate beneficial owners and key associates across all relevant jurisdictions.
Other due diligence	Other specialist reports may also be required as part of the wider due diligence process, for example, property surveys, pension reviews, environmental audits, health and safety investigations or actuarial valuations.

3.4
Documents draft

Buyers and sellers negotiate the sale and purchase agreement (SPA) and other ancillary documents.

The information gathered during due diligence feeds into the terms of these documents. The drafting of the SPA is often a lengthy process and input from all parties and their advisors is required.

3.5
Disclosure

In addition to data room information provided, sellers prepare and deliver a disclosure letter and bundle.

Information may be received through disclosure which was not previously identified during due diligence and may extend or reopen negotiations. If the buyer needs additional protection (e.g. additional warranties, specific indemnities) as a result of any updated disclosures, the sale and purchase agreement may be renegotiated.

3.6
Exchange

The sale and purchase agreement and disclosure letter are finalised and signed – known as the exchange of contracts. The parties are now committed to completing the sale and purchase in accordance with its terms.

3.7
Completion

At completion, ownership of the company or business being acquired is transferred to the buyer. Completion may occur simultaneously with the exchange of contracts but this is not always possible.

Certain conditions may need to be fulfilled or third-party consents obtained before completion can take place (consents may not be obtained before exchange or some deals may be referred to the competition authorities).

Where there is a delay between exchange and completion, the sellers will give the warranties and make their disclosures at exchange. They may be required to repeat the warranties at the completion date and, if so, may be permitted to make additional disclosures in respect of the period between exchange and completion. There may be a clause that details which significant changes in the business or issues that occur between exchange and completion need to be advised (material adverse circumstances clause), such as a significant third-party claim.

3.8
Post completion

There will be a certain number of practicalities to deal with following completion, including:

- announcements and notifications (for example, on a share sale, Companies House forms and filings)
- payment of stamp duty/taxes
- preparation of completion accounts where relevant
- other administrative or practical matters to help integrate the target into the buyer's group or organisation, such as amalgamation of insurance programmes.

04 Risk and insurance due diligence

It is important for a buyer to determine whether a target has in place a robust and transparent process for its identification and management of risk. A comprehensive due diligence exercise involves a detailed review of the target's business activities and its associated risk management strategy.

The current Financial Reporting Council (FRC) 2018 UK Corporate Governance Code (2018 Code) was published in July 2018. This code has been designed to set higher standards of corporate governance in the UK to promote transparency and integrity in business. On 10th December 2018 the first Wates Corporate Governance Principles for Large Private Companies was released which contained six principles and supporting guidance to help large private companies comply with new regulations. One of these principals relates to opportunity and risk, noting that a board should promote the long-term sustainable success of the company by identifying opportunities to create and preserve value and establishing oversight to identify and mitigate risks. The importance of scrutinising management of target risks during diligence is further heightened by this code.

Diligence focus should determine the extent to which the target delivers an integrated, comprehensive risk management programme that is based on a portfolio view and employs consistent organisation-wide processes, methods, reporting and systems which enable the business to prioritise its risk management investment effectively.

Risk appetite and organisational strategy should be aligned and evidenced with management considering the entity's risk appetite in evaluating strategic alternatives, setting related objectives, and developing mechanisms to help identify potential events and establish responses, reduce surprises and associated costs or losses.

It is important to understand whether robust risk information has been gathered to facilitate effective management assessment of overall capital needs and enhance resource allocation driven by an informed understanding of priorities and the cost/benefit of risk mitigation controls.

4.1
Risk due diligence

There are a number of elements considered essential to the success of an organisation's approach to managing risk and the following areas of diligence enquiry should be specifically considered when reviewing the target's risk profile and wider risk management strategy:

- does the Board understand the priority business risks and how those risks are being addressed?
- does management have a clear vision of how the organisation is managing risk across the various business units with its diverse portfolio of products spread across geographies?

- are critical processes, systems and people aligned with the company's business strategy?
- is the risk culture integrated with the corporate culture, i.e. working behaviours and practices?
- does the risk management function exist to drive business performance in addition to fulfilling compliance requirements?
- is risk management and business planning being fully integrated and reflected within supporting procedures and guidance?
- does management recognise that the key to growth and value creation is effectively identifying and rewarding good risk management, while at the same time creating a balance between protecting the company's assets and identifying opportunities?
- is risk identification and assessment an ongoing integrated enterprise-wide effort and not a sporadic activity for certain functions within the organisation?
- does the organisation have a specific process for the identification, management and reporting of emerging risks?
- does a 'dashboard' style of management reporting based on key performance indicators and key risk indicators exist across the organisation?
- are decision-makers confident about the magnitude of uncertainty that exists in respect of their organisational objectives and/or strategic goals?

Some exposures can be transferred and addressed through insurance solutions (the appropriateness of which can be determined via specific insurance due diligence enquiries). Where this risk transfer approach is not possible or is not considered optimal, exposures need to be managed through other means; depending on the nature of the target, diligence can be extended to determine suitability of wider risk management practices including in relation to contract, credit, supply chain, intellectual property or cyber security risks, together with associated business continuity planning.

4.2
Insurance due diligence

From an insurance standpoint, there are several key areas that need to be contemplated in due diligence:

- identification and addressing of pre-closing insurance-related liabilities that may be acquired with the target
- determination of whether the target's current and historical insurance protections are fit-for-purpose and whether there are any un- or under-insured risks
- management of future risks via an optimal approach to insurance purchase post-completion
- highlighting any changes in the risk and insurance budget post-close – the cost of insuring and/or funding of risks can be significant and large changes need to be considered within the financial due diligence
- estimate any one-time insurance-related costs associated with the transaction
- consider areas where insurance can provide transaction solutions
- minimise integration costs of the post-completion programmes.

04 Risk and insurance due diligence

It is relatively rare for the insurance due diligence to identify anything that will derail the deal, but it may, for example, uncover issues that will affect the purchase price of the target company and this is especially relevant in highly leveraged deals.

Lenders often insist on sight of the insurance due diligence as a loan condition and may even insist on the purchase of additional insurance limits or policies.

Additionally, information disclosed, and issues identified during diligence may affect the drafting of the SPA and how liabilities are transferred or retained. In fact, a review of the SPA from a risk and insurance viewpoint can help prevent future serious issues. For example, a SPA may include the buyer accepting liability for products already in circulation without associated consideration of whose product liability insurance will provide cover for this risk.

Key areas of enquiry are detailed below but these should be considered in the context of the level of review required by a buyer - some buyers only want to consider specific/key issues whilst others may request a comprehensive review.

4.2.1 Key areas of enquiry

- determine the current and historic business activities of the target; what are their markets, products and services, both current and discontinued; what research and development programmes are in place?
- obtain details of production facilities and all other sites, including any under construction?
- identify the geographical spread of the target company and if there a need for a separate investigation in each major territory?
- understand the target's key dependencies, e.g. on suppliers, customers or inter-company
- discuss with management the worst-case loss scenario(s) contemplated by the target; has this been formally modelled, e.g. via an estimated maximum loss study?
- determine if there any outstanding insurer mandated risk improvements; if so, what is the plan for completion together with the budgetary cost implications?
- review the loss profile; is there is a pronounced frequency or severity of claims and have insurers accepted liability for any significant outstanding claims? Is there a need to obtain an actuarial valuation of open claims; if outstanding claims are understated or inadequately reflected, this will have a distortive effect on the company's operating costs and trading performance. Further, does the accrual practice and process for open and notified claims look robust or does it merit detailed review?
- understand if there is any outstanding litigation that may create uninsured exposures?
- identify if recent environmental audits have been carried out in respect of owned and occupied locations and whether there have there been any previous incidents involving actual or alleged pollution?
- determine if policies are in the name of the

target company or if the target is part of a group programme; in tandem, do any of the policies contain change in control language and to what extent can the existing policies continue post acquisition or will the buyer need to arrange a new programme?

- can the target be included in the buyer's existing arrangements; if so, what are the target programme renewal dates or cancellation provisions?
- if the existing policies are cancelled, who will receive the return premiums?
- consider the appropriateness of current and historical insurance arrangements (cover and cost)?
- are the liability policies underwritten on a "loss occurring" or "claims-made" basis?
- are there additional policies that need to be bought due to gaps in cover and what is the likely cost impact?
- where there has been target participation in wider seller group programmes, will there be ongoing access to such policies (for pre-close loss events); have any aggregate limits of indemnity under such policies been eroded by past claims from other members of the seller group?
- determine if there is a draft "transition services agreement" in place articulating the separation process of the target business from the seller?
- establish the security rating of each of the seller's past and current insurers; where long-tail exposures identified will need to obtain details of all relevant historical liability insurers
- identify if any of the target's insurers have gone into liquidation and review any scheme of arrangement, recovery process and buyer's entitlement to such proceeds
- determine if there a significant level of self-insurance under the seller's/target's programme (i.e. captive or losses retained by the operating company); if so, how is this funded and will the buyer have access to that fund for pre-completion incidents notified after completion?
- if a captive has ever provided direct coverage to target operations, the security of the captive should be reviewed, whether it is transferring as a subsidiary of the target or remains as a seller subsidiary, and it should be determined if the captive programme was fronted? For any risks that are not fronted, the captive's financial accounts and reinsurance programme would need to be reviewed.
- examine if a 'mutual' has ever been involved in the insurance programme; if so, it needs to be established if there are any outstanding or potential cash calls from the mutual, together with the potential liability period for such cash calls?

Please note that this is not an exhaustive list but is provided for guidance only.

4.2.2 A note on claims-made policies

Professional indemnity, errors and omissions, cyber, directors' and officers' and other liability policies, together with financial loss extensions to general liability contracts are customarily written on a claims-made basis. The general issues of acquiring a company with claims-made insurance merit specific consideration:

- if a policy is cancelled, then all cover is terminated and is of no further effect (subject to the existence of an extended reporting period clause in some cases)
- if the seller deletes a subsidiary from its group policy, this may have similar results
- a claims-made policy may not automatically cover claims made after completion for pre-acquisition events or products made pre-acquisition
- it may be difficult or impractical to arrange cover for retrospective incidents

'Run-off' cover should be put in place and maintained until such time as any claims arising from prior events have materialised.

4.2.3 A note on directors' and officers' liability (D&O)

The purpose of D&O insurance is to indemnify the directors and officers of an organisation for claims brought against them personally but only when and to the extent that such individual is acting for and on behalf of the company in their capacity as a director or officer.

This policy would not provide cover for the directors and officers for any contractual liabilities incurred under the sale and purchase agreement unless such liabilities are a direct result of them being in their capacity as a director or an officer of the company. Please consider Section 9 for insurance solutions available for contractual liabilities incurred under warranties in the sale and purchase agreement.

Most D&O policies contain a 'change in control' clause that automatically puts a policy into 'run-off' following a change in the control of the company. This means the policy will only cover any claims made after the change in control date relating to allegations of wrongful acts occurring prior to that date.

It is common for the current policy to be put into 'run off' for a period of up to 6 years (depending on jurisdiction). This will ring-fence historical liabilities of the past and current directors. A new policy can then be incepted at transaction completion for post close wrongful acts or the buyer can incorporate the target business into its own group arrangements. This means that the go forward programme is not eroded by historical claims over which the new owners had no control.

Given the increasingly difficult hardening market conditions, with sufficient prudent consideration to risk appetite and loss control, the utilisation of captives either as an alternative or alongside market placements, can be a viable solution for Sides B & C. Serious consideration should however be given to the intricacies of captives for this purpose and the use within D&O more generally raises questions for clients considering these alternatives to purchasing traditional insurance:

- The cost of establishing and running a captive. Captives need to be regulated in the relevant jurisdictions.
- D&O liabilities can be very long tail risks. When considering the cost vs paying premium to a traditional insurer, clients will need to consider the cost of capital aligned to legacy liabilities.
- D&O liabilities tend to be low frequency and high severity. It is therefore imperative to align assumed risk to risk appetite alongside the captives existing insurance lines.

Side A presents specific challenges related to ringfencing of assets in the event of the insureds insolvency and whether the assets within the group are protected from creditors, the circularity of funding when looking to indemnify a director if the insured is legally prohibited from doing so and the independence of claims handling which may concern individuals covered under the policy if any conflict arises with their employer (past or present).

D&O cover issues and arrangements should be included in the SPA – for example where the target business is the subsidiary of another company, provisions/ cover issues relating to historical indemnification and access to the parent company policy should be addressed.

Of note, other policy classes can contain change in control language and so similar “run-off” issues may need to be addressed.

4.2.4 Future insurance programme

The insurance due diligence report should include commentary on the recommended future insurance programme structure and associated scope of cover and cost including in relation to possible integration into the buyer’s programme. Any significant changes in scope or increases in the cost of the insurance will need to be included in the financial projections and may affect the purchase price. In a hardening or changing insurance market environment it is particularly important to articulate the likely, future impact on coverage terms, available capacity, self-insured retentions, loss control requirements and programme costs; further, where new policies need to be established for closing, the level of exposure data that must be collated to facilitate placement, the underwriting process and associated timescale needs to be stressed so that it is fully understood and built into the deal time-table.

Areas that should be covered include:

- additional policies that need to be bought (including any “run-off” policies)
- recommended increases in limits
- coverage gaps to be addressed
- new/additional collateral required to support the programme
- budget for insurance-related capital expenditure
- minimum solvency requirements of insurers (often a requirement of lenders).

4.2.5 Insurance-related review of sale and purchase agreement

Although the transaction may take the form of the purchase of shares, which usually involves the acceptance of past liabilities, or an 'assets only' purchase where most past liability is left with the seller, in practice, the liability allocation may not be so absolute and the SPA needs to be closely reviewed.

From a risk and insurance point of view, the SPA should clearly allocate responsibility for liabilities that arise from:

- incidents occurring and notified prior to completion (these will be detailed in the claims experience)
- incidents incurred before completion but not yet notified
- incidents arising after the completion date but caused by an error, an omission or a defective product manufactured and/or supplied prior to the completion date
- pre-completion acts of directors or officers of the target company
- occupational disease or other injury claims where harm may be caused both before and after completion; please note that if the deal falls within the EU Transfer of Undertakings (Protection of Employees) Directive, it may not be possible to allocate such liabilities within a sale and purchase contract – advice from legal advisers must be obtained
- movement in reserves on outstanding liability claims after completion, particularly where the risk is subject to a large deductible
- open business interruption claims where a seller's insurer may cease settlements post disposal
- historical pollution/contamination including unknown pollution as a general result of historical site use(s)
- operating levels of self-insurance that may differ from insured excess level, i.e. the target company may be protected by the head office funding of losses in excess of a lower level and up to a level at which insurance is purchased.

If the buyer adopts pre-closing liabilities the availability and cost of coverage for such risks needs to be quantified, for example, the purchase of retrospective products liability. The buyer can then use this information in the price negotiations. For some pre-closing liability, it may be preferable to seek indemnities from the seller; however, this is not always the preferred route if the seller has limited funds or will not provide indemnities (for example, a sale by an administrator). In such cases, there may be insurance solutions available to give comfort to the buyer (see Section 9 – Transaction insurance).

Additional insurance-related issues that should be considered in the SPA include:

- which party receives any return premiums?
- who is responsible for paying any premium adjustments on pre-completion policies?
- which party has responsibility for paying deductibles or excesses on pre-completion claims made post-completion?

- the cost of providing administration support to the buyer to make post-completion claims arising from pre-completion incidents (for example, providing payroll information on employers' liability claims)
- which party will pay for any retrospective or run-off cover needed?
- how will future and outstanding claims be handled?
- the provision of up-dated claims experiences
- the adequacy of insurance-related warranties and indemnities

4.3
Supplementary areas of enquiry

Depending on the business and risk profile of the target, diligence enquiries can be expanded into other specialist areas some of which are detailed below.

4.3.1 Credit and cash due diligence

An in-depth analysis of the target's trade receivables ledger in addition to a working capital diagnostic can help determine potential insurance backed solutions that can improve working capital cycles and reduce costs associated with funding. Diligence enquiries include:

- analysis of total debt by country and sector risk levels
- assessment of counterparty risk and probability of default
- actuarial modelling of expected credit loss with and without the purchase of credit-insurance
- examination of key working capital and credit risk factors
- determination of predicted number and value of payment defaults per annum
- consideration of bad debt provision requirements (under IFRS 9 new accounting standard)
- assessment of counterparty country & sector
- review of potential insurance-backed financial solutions, including in relation to trade payables, trade receivables, contingent liabilities, and pension/ investments

4.3.2 Supply chain analysis

The supply chain architecture should be thoroughly reviewed to ensure that a target business is viable on a "going concern" basis. In addition, the diligence feedback can have particular relevance in determining the suitability of the target's insurance coverage, especially for property damage / business interruption and product liability risks. Diligence enquiries would examine whether:

- property asset values are known
- sites which have significant business interruption exposure have been identified; the supply chain may have many significant single-point exposures, e.g. reliance on a single packaging site or raw materials from a single source, capacity restrictions, export through a single terminal, etc.

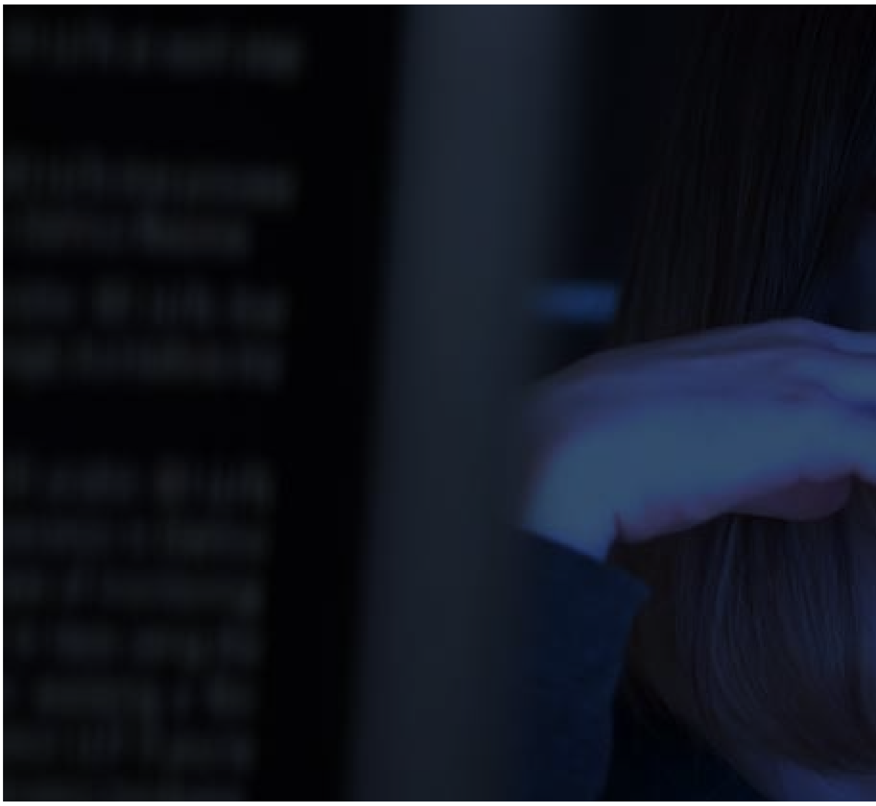
- there is any redundancy/contingency built into the supply chain architecture; this gives an indication of how resilient the supply chain may be in the event of a large-scale incident especially those of low probability, high impact profile such as a pandemic
- the new target assets add to an existing buyer exposure, e.g. are acquired assets in the same flood plain/ earthquake zone as existing company assets?
- critical suppliers have been identified
- key information (e.g. design data) is stored in a secure manner
- inventory levels/safety stock are kept along the supply chain
- products and components are traceable throughout the supply chain
- there a clear policy for returns/end-of-life usage
- there a mechanism to spot where products may be misused or cause an adverse reaction
- the supply chain holds any long-term liabilities (e.g. environmental liabilities, occupational health exposures, etc.)

Among the many impacts of the coronavirus pandemic (COVID-19) has been its effect on supply chains. The pandemic has highlighted the risks of globalisation, relying on only a few suppliers or being tied to rigid production and distribution processes and many organisations are looking to re-evaluate their situation. These risks were particularly high-lighted across the food industry which had to overcome rigid supply chains and sudden unexpected spikes and falls in demand to make sure food items could be delivered to the right customers.

4.3.3 Contract reviews

It is often insightful to understand what contract risk management practices are employed by the target during key customer, supplier and other third-party contract negotiations and to review standard and/or a sample of the main contracts entered into by the target company. There are various potential issues that should be considered during such a review, including:

- specific terms relating to insurance purchase in standard purchase/ service/



sale agreements such as the provision of/ requirement for certain cover limits/ conditions
- uninsured liabilities accepted in contracts
- waivers of subrogation given by contracts and how these could affect future policies
- the extent of cover required and any gaps between full repairing leases and landlord's insurance.

4.3.4 Business continuity planning

Business continuity plans, commonly referred to as BCPs, describe the arrangements in place and the actions required to ensure that the critical business activities of the target company can be recovered and continue to operate following a disruption within an acceptable time frame.

The existence and integrity of such plans, including routine testing protocols, should be contemplated in diligence.

Further, if there are plans to merge or share previously separate business activities or processes following completion of the transaction, the BCP needs to be urgently reviewed and potentially amended to reflect the way in which these processes will be carried out post-merger.

05 Human capital due diligence

Human capital due diligence is focused on the identification and quantification of material employment related risks and liabilities at the target company and seeks to determine any potential employment and employee benefit related issues and additional costs which could arise post completion.

5.1
Human capital due diligence

There are several key areas of review which are covered in a human capital due diligence exercise:

- identifying and assessing the target company's pre-closing employee benefit arrangements and liabilities, including any obligations relating to multi-employer arrangements:
  - what is the geographical spread of the target company and is there a need for a separate review in each major territory; employee benefit provisions are typically dependent on local country practices and requirements but may be driven by global principles?
  - will there be a loss of group HR and employee benefit related plans and functions that will need to be replaced or set up in a carve-out situation?
  - what is the extent to which HR and benefit related costs have been allocated sufficiently to a carved-out entity historically?
  - whether there are any defined benefit pension or other post-employment benefit plans in place, including any statutory defined benefit plans?
  - if there is a change in control provision in management contracts or triggers in pension plans requiring immediate cash payments?
  - if there are any equity-based compensation plans in place?
- consideration of employee benefit plan funding requirements and identification of any future increases to employment costs
- analysis and evaluation of retirement and benefit plan design, eligibility, compliance and market competitiveness review
- identifying any change in control payments made to executives and key employees as a result of the transaction (i.e. retention plans/sale bonuses)
- reviewing compensation plans in place (cash and equity) and determining the impact of the transaction on these arrangements (e.g. early vesting of equity plans)
- managing future risks by determining the proposed post-closing structure of employee benefits provision after considering the cost of the employee benefits programme and the nature of liabilities that will be transferring across
- have there been any previous transfers of employees into the target under the EU Transfer of Undertakings Directive. If so,

there may be certain groups of employees on different terms and conditions of employment and/or employee benefit provision

- understanding the employee relations landscape; determining if any recognised trade unions and collective bargaining agreements are in place and whether there are any commitments for future increases to pay and benefits; what are the consultation and communication requirements to unions, works councils and employees?
- reviewing severance plans in place and any other arrangements relating to termination of employment
- identifying any employee benefit plans operated at parent level which will not transfer with the transaction and will need to be established for Day 1 (in a carve-out situation); understanding the costs associated with implementing stand-alone arrangements
- determining how any new compensation and benefit plans will impact cash flow and P&L
- understanding the impact on the cost of HR infrastructure, systems and services such as payroll, HRIS and shared services, especially in a carve-out, where there are likely to be separation issues and additional costs
- reviewing the pre- and post-organisational structure, including identifying key personnel, proposed management team structure, role changes, and potential future retention and compensation solutions
- highlighting any expected changes to the HR budget as result of the change in company ownership; the costs of updating the HR infrastructure, insuring or funding employee benefits provision can be significant
- minimising any integration costs or identifying synergies for the post-close benefit programmes, for example by integrating benefits or reviewing third-party provider pricing

HR risk profile

When reviewing the HR profile of the target company, a number of key considerations should be addressed:

- What is the geographical spread of the target company and is there a need for a separate review in
- each major territory? Employee benefit provisions are typically dependent on local

country practices and requirements, but may be driven by global principles
- Are there unions or collective bargaining agreements in each territory?
- Will there be a loss of group HR and employee benefit related plans and functions that will need to be replaced or set up in a carve-out situation?
- Have HR and benefit related costs been allocated sufficiently to the carved-out entity historically?
- Have there been any previous transfers of employees into the target under the EU Transfer of Undertakings Directive. If so, there may be certain groups of employees on different terms and conditions of employment and/or employee benefit provision
- Are there any defined benefit pension or other post employment benefit plans in place, including any statutory defined benefit plans.
- Will there be a change in control provision in management contracts or triggers in pension plans requiring immediate cash payments?
- Are there any equity-based compensation plans in place?
- How will any new compensation and benefit plans impact cash flow and P&L?
- What are the consultation and communication requirements to unions, works councils and employees?

Enquiries can be tailored to address the impact of topical issues such as pandemics.

5.2
Employee-related review of sale and purchase agreement

The SPA should contemplate:

- the allocation of responsibility for past and future provisions related to employees, such as pension and medical liabilities
- terms and conditions and employee transfers such as providing comparable compensation and benefits post close
- purchase price adjustment for employee benefit provisions
- severance in cases where employees decline transfer
- transition services that will be provided post transaction
- HR-related disclosures, warranties and indemnities

05 HUMAN CAPITAL DUE DILIGENCE

06 Cyber security due diligence

From a technology and information security perspective there are several key risks a buyer needs to consider before acquiring a target, namely:

- the target's ability to generate revenue in the event of an interruption to key systems, processes and data which will depend on how dependent the business is on technology in the first place, how well prepared it is to minimize the impact of such an event, how likely it is for such an event to occur, which in turn depends on how secure it is and on the level of interest amongst the hacking community to damage it
- the security of the target's interface with 3rd parties, particularly those accessible to the public (internet facing computers)
- the contractual liabilities and regulatory obligations the target retains in the context of personally identifiable information (PII) it stores or is stored on its behalf which, typically, relate to breaches of privacy and the associated damages
- the target's contractual liabilities in a business interruption event, typically arising from delay in supply
- the target's ability to generate revenue in the event of a disclosure of its own confidential information (e.g. source code); typically, a buyer should perform at least a cursory assessment on whether such a disclosure has not already occurred
- the exposure of the buyer's existing assets as the target is integrated into the buyer's business, typically, arising during the integration phase from the target's computers being more directly connected to those of the buyer

6.1
How can cyber security risks be assessed in diligence?

Cyber due diligence looks at a business through the lens of a hacker, generally having no access to the target except for the internet. Through this lens it is possible to build a profile of the target as seen by these threat groups. This assessment may focus on the following:

- building intelligence from 'dark' websites associated with hacking activity, often located on parts of the internet that cannot be found through typical search engines
- searching the internet infrastructure for assets related to the target to locate the target's internet facing computers and vulnerabilities
- communicating with the target's internet

facing computers to understand their configuration and weaknesses
- searching the internet for the online behaviour of the target's employees
- researching information on the target's financial position, customers, and business model to estimate the possible impact of a cyber event
- where privileged access to the target is available, communicating with management to understand the target's security posture from an internal perspective
- where privileged access to the target is available and management have provided approval, communicating with the target's internet facing computers and attempting to circumvent them to go deeper into the target's network

6.2
How can cyber risks be offset in a deal context?

A buyer's first step towards mitigation is awareness which can have several levels and a buyer should generally seek the level of awareness with which they are comfortable in the context of the target's business. Once a buyer has a degree of awareness, cyber risks are typically offset through one or more of the following methods:

- a buyer can request target management investigate the findings; with this approach management typically validate findings or provide further context to their occurrence. Occasionally, and if the deal timeline is aligned, the target may be willing to redirect ongoing investment into the findings; a buyer should be aware of anti-trust considerations in this approach
- a buyer can address findings through a post-deal remediation plan; typically, this is targeted at the first 100 days post-close. Cyber risks are generally magnified throughout post-close as the integration period is inherently riddled with risks and possible impact amplifications as threat groups attempt to exploit this
- a buyer can offset the identified risks within the deal value; if a buyer is able to quantify the identified cyber risks, then their negotiating position in this context is generally strong
- a buyer can seek additional warranties & indemnities on the deal to cover identified cyber risks. Buyers can also seek the purchase of cyber cover and warranty and indemnity insurance on the target to offset specific deal risks

07 Intellectual property due diligence

Intangible assets have become the foundation of our global economy changing the business risk landscape and requiring a different approach to the traditional management of risk.

Historically, the lens through which an intellectual property (IP) strategy was examined revolved around the strength of the legal frame work for patents, copyrights, trademarks, and trade secrets. Ownership is, however, only one aspect of a larger picture. The volume and scope of a target's intellectual property portfolio also requires an understanding of the competitive outlook for related IP and of the products, services and processes that the IP supports.

From an IP standpoint, there are several key areas of concern that should be covered in due diligence. In line with the comments above IP related due diligence can be split into two workstreams, legal diligence and business diligence:

7.1
IP legal diligence

- reviewing the ownership status of all IP assets to ensure they are assigned to the target company and that the chain of title is complete
- reviewing the maintenance status of all IP assets to identify potential IP office renewal fees

7.2
IP business diligence

- assessing the alignment between the patents and the level of engineering / research and development spend and strategic IP intent
- reviewing the degree of alignment between the company's products and its IP through various metrics from patent analytics, trademark insights and other IP and risk analytics
- understanding the accumulated IP office cost to build the company's IP portfolio and the estimated future cost to maintain its active status
- assessing the high-level patent infringement exposure based on competitive patent landscape analysis
- understanding through statistical analysis the indicative frequency that the company is likely to be sued for patent infringement and the likely lawsuit cost
- highlighting potential IP risk transfer solutions through non-binding illustrations of potential terms for IP infringement insurance
- comparing the geographic coverage of the IP assets with the geographic spread of the business activities to ensure the IP covers where the products/services are made, sold, distributed, imported or used
- assessing the exclusionary strength of patents by reviewing the strength and coverage of claims and the percentage of deemed high-strength patents based on IP analytics metrics
- assessing the invalidity risk of the

company's patent assets by reviewing their age profile and the risk of seeing some semantically similar prior art emerge
- considering the financial valuation of the IP assets which can constitute a significant share of the company's value
- assessing the indirect IP exposure risk the company faces through its suppliers
- highlighting the risk of trade secret exposure
- assessing the level of active management of the company's patent portfolio to indicate if the company is still investing the areas covered by the patents
- reviewing the company's proficiency in IP management

7.3
IP risk profile

When reviewing the IP profile of the target company a number of key considerations should be addressed:

- what is the geographical spread of the target company and is there a gap in coverage between the IP and the business; will the company face increased IP risk in geographies into which it is planning to expand?
- is the target active in a litigious IP space and is the business already or likely to be targeted by patent assertion; does the acquisition change the IP infringement exposure of the target?
- is the company relying on in-licensed, third party IP and are such rights transferable to the acquirer?
- is the company relying on IP as a barrier-to-entry and is the IP strong (claim breadth) and robust enough (low risk of invalidation)?
- does the patent landscape highlight likely new entrants in the company's market?
- is the company generating a robust pipeline of protectable and/or valuable IP for its next generation of products / services?

7.4
IP-related review of sale and purchase agreement

The SPA should allocate responsibility for:

- terms and conditions relating to IP re-assignment and requirement for updating IP office records in the post execution or completion steps
- payment of IP offices fees
- handling of existing IP litigation and potential requirement for collaboration in future IP actions
- IP-related disclosures, warranties and indemnities

08 Transaction risk insurance

Transaction risk insurance can be used by the parties to an M&A transaction to facilitate the deal. Whilst such insurance policies have been in existence for well over twenty years, their use has very significantly increased over the past ten years or so, such that it is now a core feature of very many M&A transactions.

Both sellers and buyers have increasingly recognised the product's flexibility and creative ability to adapt to new situations and requirements in order to take items off the negotiating-table that could otherwise have prevented the parties from reaching agreement, thereby facilitating transactions and on terms potentially more favourable to both seller and buyer.

Generally, in a private transaction, the seller wants to:

- maximise sale proceeds
- accelerate distribution of funds
- minimise contingent risk and future balance sheet exposure/avoid an escrow (i.e. achieve a clean exit)

But the buyer wants to:

- minimise the price paid for the target company
- have as fulsome a set of warranties as possible or specific indemnities
- maximise its post-closing amount of financial recourse, in as cost-effective and straightforward a manner as possible
- protect its post-transaction relationships both with the management team who may have been retained with the business acquired and with the seller who may remain a commercial partner
- provide comfort for lenders/its board/ shareholders

Where there are gaps between the deal parties, the main products that provide transaction insurance solutions are:

- warranty and indemnity (W&I) insurance
- tax liability insurance
- contingent risk insurance
- environmental insurance

8.1 Warranty and indemnity insurance

8.1.1 What are warranties?

In the context of a company share or assets sale, warranties are contractual statements of fact about the company or asset being sold that are made within a sale and purchase agreement by the seller or by the target business's management. In share and asset deals, sellers are typically required to give a number of warranty statements covering all aspects of the company, against which they 'disclose' relevant information.

If any of these statements are untrue and, as a result, the value of the company is less than the buyer paid for it, the seller may be liable to pay damages. However, if the seller has provided information (disclosure) about the matter before the sale, the buyer has no recourse under the terms of the sale and purchase agreement in respect of a loss arising from the matter disclosed.

The main purposes of these warranties, therefore, are (i) to produce information about the company for the buyer to consider and evaluate before the deal concludes and (ii) an allocation of risk between the seller and buyer.

8.1.2 How do indemnities differ from warranties?

Whereas warranties are contractual statements of fact, from the unknown breach of which the seller may be obliged to pay for the buyer's ensuing loss, an indemnity is a contractual promise to pay for loss arising from a specified occurrence. If there are identified issues of potential losses within the target company, it is normal practice for the buyer to request indemnities from the seller. These indemnities are used to protect the buyer against particular risks or identified liabilities, for example:

- the tax deed may contain indemnities relating to specific tax issues, or
- indemnities against issues identified during due diligence, such as environmental or litigation issues

Sellers are generally more reluctant to provide indemnities as an indemnity claim requires reimbursement to the buyer on a pound-for-pound basis (without a duty on the part of the buyer to mitigate its loss). This applies regardless of whether it has affected the value of the company or if the seller previously provided information relating to that matter.

8.1.3 SPA protections

Once the seller has committed to providing warranties and indemnities and accepted the subsequent liabilities, it is standard practice to negotiate certain protections for the seller into the SPA. These limit potential liability under the warranties and indemnities. The level and extent of these provisions will be negotiated between the buyer and seller.

These typically include:

- a time limit on when claims can be brought by the buyer – generally up to seven years for tax and up to two years for business warranties
- claims below an agreed sum are excluded – a small claims bar (or de minimis)
- claims must exceed a certain threshold amount before any claim can be brought (threshold)
- a warranty cap – the maximum amount for which the seller can be liable under the SPA

In such situations, there may be a gap between the warranty cap and time limit requested by the buyer and the one the seller is willing to give. Transaction liability insurance solutions can be used to assist the parties in closing these gaps.

8.1.4 What is warranty and indemnity (W&I) insurance?

The type of buyer or seller strongly influences its attitude to the importance of title, business or tax warranties and indemnities in an SPA. For example:

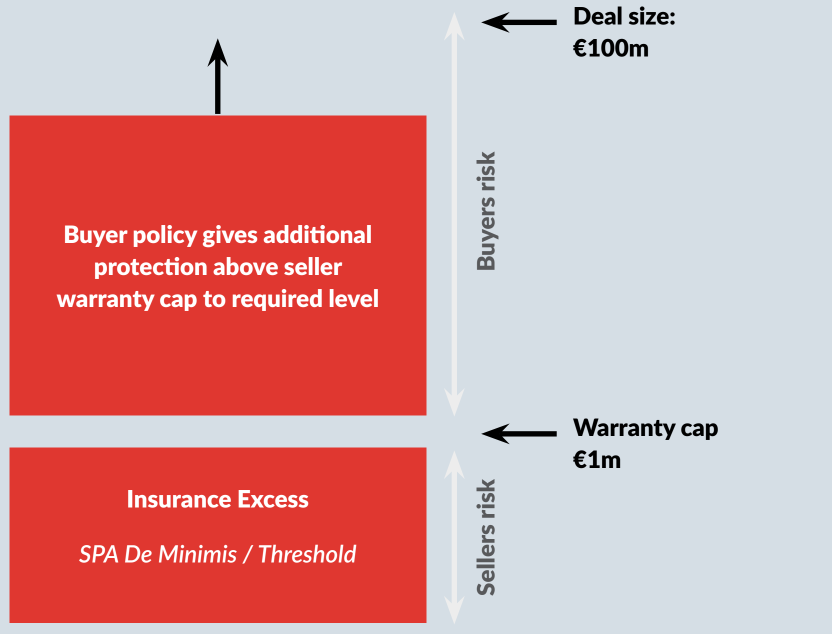
- private equity or trustee sellers are usually unwilling to provide warranties or retain meaningful liability post completion
- target companies' management are usually prepared to give warranties but will look to cap their financial liability to their sale proceeds or perhaps as little as £1
- overseas buyers (often trade) require a full set of warranties with a financially significant financial cap to 'back them up'
- certain sellers, i.e. offshore SPVs or individual sellers, may be willing to provide warranties and a financial cap but there may be concerns about the buyer's ability to recover (or the cost and effort required to do so)

When there are gaps between the buyer and the seller on the warranty cap, there are specialist insurance products that can assist. These policies cover many of the liabilities incurred in M&A transactions.

The most popular of these is the W&I policy.

This has been designed to sit behind the main deal warranties (title, business and tax) in a share or asset sale agreement and covers losses incurred by the buyer as a result of a warranty breach or the amount that could have been claimed under the tax indemnity. Cover is provided for matters unknown to the insured at inception of cover.

Figure. The structure of a W&I policy



Whilst most parties tend to put the policy in place at signing, it can be done at any point, including after completion (although it is worth bearing in mind that any matter known to the insured up to the point of inception of the policy will be excluded from cover, which is why the insured generally looks to put the policy in place at signing).

8.1.5 Types of W&I cover

The W&I policy can be taken out by either the seller or buyer in the transaction.

Table. Types of W&I cover

Seller W&I policies	A seller W&I policy covers damages resulting from a breach of warranty or tax claim against the seller under the sale agreement as well as the insured's defence costs. The seller provides warranties under the sale agreement and a policy is placed to cover its liability arising therefrom. In the event of a claim, the buyer seeks recourse against the seller under the sale agreement and the seller then makes a claim against its W&I insurance policy to recover its loss. Seller W&I policies have declined in use and represent approximately 5% of all W&I policies currently being placed in EMEA.
Buyer W&I policies	Buyer W&I policies cover the insured for losses arising from a breach of warranty or tax claim (and, also, defence costs for third-party claims). The key difference is that, if there is a loss under the terms of the sale agreement, the buyer may make a claim directly against the insurance policy without first having to make a claim against the seller under the SPA. This policy is now used where the seller offers a financial cap that is insufficient for the buying party. It can provide buyers with the comfort that they would have otherwise gained from a higher warranty cap or replace an escrow. An increased understanding of this has led many sellers to reduce their financial cap still further, often to offering no meaningful direct recourse to the buyer, leaving it to the buyer to obtain its requisite level of cover directly from the W&I policy. In addition, in some deals, it may be that the warranty survival period offered by the seller is insufficient. The buyer could take out a W&I policy that covers it beyond the sale agreement limitations (up to seven years for title and capacity and tax warranties). Buyer insurance has also been used to provide additional financial security to that offered by sellers. This has been of most help where there are concerns about the collectability of claims under the sale agreement.
Seller to Buyer proposals	Sellers often take steps towards arranging W&I insurance policy which can be "flipped" to the buyer when a buyer is identified, following the bidding stage. These so-called "flips" can be structured either as "soft" or "hard" staples. A soft staple is one where the sellers have conducted an exercise through their broker to gauge conceptual appetite amongst insurers to insure the transaction and then include a summary of initial W&I insurance terms available (similar to heads of terms) in the data room. The seller's broker will then discuss with the potential bidders the terms of the proposed policy and the placement process, with a view to progressing the insurance workstream thereafter directly with the buyer who will buy a buyer's policy. A hard staple is one where the sellers progress the insurance workstream beyond merely conducting the preliminary indication-obtaining exercise of a soft staple with insurers and go on formally to appoint an insurer to commence underwriting, before later flipping the policy to the buyer in order to complete this process. Like a soft staple, a hard-staple W&I policy will ultimately be a buyer's policy.

8.1.6 How and why is W&I insurance used?

W&I insurance can be used to secure 'A' rated financial security for warranty and tax indemnity claims for up to seven years.

W&I insurance is used for a variety of reasons in M&A deals, including:

- selling shareholders' concerns that they cannot fully utilise their consideration due to the long-term nature of the financial cap
- selling company's concerns that the company balance sheet may be insufficient to cover claims or that retaining such liabilities on the balance sheet may not be the most efficient deployment of capital
- private equity seller's or trustees' refusal to give business or tax warranties
- buyer's worries about collectability (or the cost thereof) if the seller is based outside the UK, is a group of individuals or has a solvency issue
- alleviation of buyer concerns about having to sue the other party and damage a potential future business relationship
- allowing closed end funds to avoid residual liabilities when winding up by using W&I to achieve clean exits

W&I insurers always try to offer cover that mirrors the warranties in the SPA as closely as possible (or even enhances their scope) but there are some areas for which full cover is not available or difficult to obtain. Common exclusions include:

- matters which have been disclosed by the seller in the context of the transaction (vendor due diligence, data room, disclosure letter)
- matters which are known to the buyer
- contamination/pollution
- condition of property
- condition of assets/under-provision for dilapidation
- fines and penalties uninsurable at law
- forecasts/forward-looking warranties
- fraud of the insured party
- pension underfunding
- transfer pricing and secondary tax
- other tax matters such as Diverted Profits Tax
- post-closing price adjustments/leakage indemnities
- bribery and corruption in high risk jurisdictions
- consequential loss
- product liability
- subjective warranties; e.g. those which warrant the "appropriateness" of a matter

Some of these exclusions may be tailored or removed altogether if the insured is able to provide sufficient comfort to the insurer based on detailed due diligence on the relevant issue(s).

It is also important to bear in mind that the scope of the due diligence must cover the scope of the warranties the insurer is being asked to insure. Otherwise, gaps or deficiencies therein may lead to gaps in the scope of cover the W&I insurer is willing to offer (for instance, in relation to a foreign jurisdiction with substantial revenues that has not been included in the due diligence exercise).

8.1.7 The process for obtaining W&I terms

Placing a W&I policy usually takes approximately two to three weeks, in parallel to the deal timetable. There are two stages in the process:

- **Stage 1:** non-binding indication – insurers will provide feedback based on an initial review of limited deal documents. They will give estimated pricing and policy excess and highlight any potential problem areas. These are similar in nature to heads of terms provided in deals.
- **Stage 2:** binding quotation – if the initial offer is of interest, a binding quotation will be obtained from one selected insurer. The insurer will conduct a detailed review of the deal information which generally includes a call with the deal team before offering binding terms.

8.1.8 The cost of W&I insurance

The premium for this kind of insurance is calculated as a percentage of the limit of liability. This percentage will vary depending on a number of factors, such as: (i) the level of the retention, (ii) the size of the transaction, (iii) the limit of liability, (iv) the nature and location of the target company/ asset, (v) the terms of the warranties, and (vi) the policy period.

In addition, at the second stage, W&I insurers use external lawyers to assist them in their underwriting review. Although insurers will require the prospective insured to agree to commit to paying these fees before they will commence the underwriting process, some will ultimately waive these fees if the insurance is bought, whilst others will look to charge them in addition to the premium.

8.2
Tax liability insurance

Sometimes, known issues can become a stumbling-block in negotiations between the seller and the buyer and an obstacle to the successful completion of a transaction. Whilst the parties may have obtained the necessary expert and legal opinions, sometimes these still do not provide the necessary comfort to enable the buyer to accept the risk on their balance sheet. The most common area where this occurs is in relation to tax.

08 Transaction risk insurance

A tax liability insurance policy is designed to ring-fence known liabilities that may arise despite an expert's favourable review. This type of insurance covers the risk of an adverse outcome and the policy will cover both the quantified risk and, if required, late payment interest, insurable penalties and defence costs which could arise upon a tax authority challenge to a tax position.

Tax liability insurance can be used in a wide range of situations, both in the context of an M&A transaction and on a standalone basis (i.e. not involving a live M&A transaction), for instance:

- to protect the buyer against a tax risk identified in their due diligence analysis of the target company. This kind of insurance is often used instead of a conventional "deal protection" arrangement, such as seller indemnity, deferred purchase price or price reduction
- to protect a seller that has given an indemnity to the buyer of a target which is exposed to a tax risk
- to mitigate tax risks which arise as a result of the deal structure or subject-matter – e.g. to cover a withholding tax which might apply to the payment of purchase consideration by a buyer where a "non-resident capital gains tax" applies
- where a fund or legal entity is winding itself up – and residual tax liabilities are identified which might absent the insurance and delay the winding-up from occurring
- in a "distressed" situation, where tax risks are identified which might otherwise complicate a restructuring exercise

These policies tend to be most useful in situations where there is a disagreement on the interpretation of the risk and can provide certainty for all parties. The use of tax insurance policies has grown very considerably in the last approximately five years.

8.3

Contingent risk insurance

Contingent Risk insurance is the basket into which can be placed all other risks and liabilities which may become a roadblock in a M&A transaction.

There is a growing market for this type of insurance and significant insurance capacity available.

It can enable an insured to ring-fence and transfer miscellaneous potential contingent liabilities and exposures which may exist and which may not be susceptible to being dealt with in the terms of the transaction.

It is particularly useful in the context of a sale of a business where the contingent risks would otherwise prevent the sale proceeding or would have a significant impact on the price to be paid.

It can cover losses arising from any form of contingent risk but it is most commonly used in relation to current or anticipated litigation, arbitration or other disputes.

Cover in relation to litigation risks can be purchased in a number of forms:

- contingent risk insurance: cover for possible exposure to litigation in the future
- after the event (ATE) litigation insurance: cover in relation to adverse costs awards
- litigation buy-out insurance: cover usually purchased by defendants to transfer the litigation from the defendant's books, to act as a stop loss for pending litigation or to serve as a hedge against the reversal of a judgment on appeal

8.4
Directors' and officers' liability for public offerings

Where a company raises funds through a public exchange, certain liabilities are incurred above those undertaken in the usual course of business. Such liabilities incurred in the issuance of a prospectus or listing particulars include a duty of care towards the proposed shareholders and additional regulatory obligations.

Whilst many of these obligations fall under the directors' and officers' usual remit, we would highlight that most D&O policies will not cover these additional liabilities as standard. If it is included, the limits and cover provisions under this policy may be insufficient to cater for the specific exposures incurred when issuing a prospectus or listing particulars.

Depending on the amount of capital raised or the listing exchange, there are a number of insurance routes to consider. Firstly, the existing D&O policy of the company could be extended; this is often the best route for small capital raisings on AIM (Alternative Investment Market) for example. Secondly, for larger listings, the company will usually consider whether a separate policy is required for this exposure. A public offering of securities/prospectus liability insurance can ring-fence these liabilities for up to 6 years or where the statute of limitations dictates a longer period in certain cases and ensure that there is adequate cover in place for both ongoing and retiring directors.

8.5
Environmental liabilities

Cover is subject to an environmental audit/due diligence by an approved consultant for each location/across the portfolio. Where there are concerns, environmental surveys can be commissioned as part of the mergers and acquisitions process and form the basis of the underwriting data requirements.

The process is similar to W&I in that an environmental due diligence report(s) can initially be used to make an assessment of cover, pricing and any key site and/ or portfolio/deal specific exclusions. At an appropriate time in the deal process, a preferred insurer is usually chosen and negotiations commence to formalise terms and minimise any deal specific exclusions/ issues. Note that environmental insurance is incepted either by the buyer or the seller or by both parties on completion and not signing of the transaction.

8.6 Intellectual property and intangible asset exposures

Over the last 40 years there has been a rotation from traditional hard assets towards a predominance of intangible assets for many operating companies. This shift has dramatically changed the exposures that companies face and the insurance market has begun to respond:

IP Infringement Insurance provides coverage for allegations that the insured has infringed a third party's intellectual property. It also responds to charges of invalidation, including inter parte reviews.

- in a transaction, the buyer may elect to purchase a policy to transfer specific IP risks related to major contracts, or a particularly innovative / non-traditional part of the business that could evolve from disruption into litigation.
- for corporate buyers, the acquisition of a target can significantly change the IP infringement exposure – the enhanced distribution that the corporate buyer offers can awaken competitors and increase the likelihood of litigation
- where the motivation for acquisition is the underlying technology of the target, the ability to transfer the risk of a patent being invalidated and so reducing the competitive edge anticipated, can bolster the acquisition rationale

IP theft insurance provides coverage in the event that a client's critical trade secrets (the "crown jewels") are stolen.

According to a 2013 survey by Symantec, 50% of departing employees keep confidential information from their employer and 40% plan to use it in their new job. The increased employee turnover caused by a transaction exponentially increases the likelihood of trade secret misappropriation but, until recently, no insurance solution has existed.

It is now possible to secure $100M+ of coverage for scheduled IP assets stolen by departing employees, or third-party actors.

8.7 Other types of insurance used in transactions

Other types of insurance that can be used in a transaction to remove deal impediments or unlock additional value include the following:

Table. Other types of insurance used in transactions

Classes of Insurance	Description of Cover
Key person	Insurance can be taken out if it is perceived that the death or disablement of a key person employed by the target company would have a material effect on business performance and cause an unexpected loss which from would be difficult for the target company to recover.
Credit	Newly reorganised companies need secure and low-cost finance, and this can be a challenge when there is no financial track record. There are insurance solutions available to help enhance a company's receivables asset and to assist in growing the business and protecting shareholders' investment.
Deferred Consideration	Credit insurance and surety can be used as an alternative to purchaser collateral (e.g. cash escrow of letters of credit) for deferred payments due in connection with transactions. This can improve working capital, support negotiation of purchase terms and transfer purchaser credit risk.
Defective title indemnity	For many reasons, title to land may not be considered 'good title', e.g. there may be an absence of rights of way, title deeds missing, etc. that cast doubt on the validity of the title to the land. A defective title policy covers capital, damages, loss and legal expenses should another party be able to show better title to the land or prevent the use of rights of way or services. Title insurance may also be used to avoid the need for extensive legal reviews of all leases and speed up the purchase process. It is also typically possible to obtain insurance to cover known third party rights in respect of land, for example restrictive covenant insurance is available if it is thought that a property may have been used in breach of a restrictive covenant or the buyer intends changing the use of a property that may breach such a covenant.
Rights of light issue	In today's environment with the ever-increasing presence of skyscrapers, many clients are facing issues with regard to their neighbours 'rights to light' for new developments. There are now insurance policies that can protect clients from unexpected outcomes in relation to these issues.
Transaction at under value policy	When buyers purchase a distressed business, or part of one, there is the risk that the transaction is set aside by the courts for being deemed to be at 'undervalue'. A specific insurance policy may be obtained, depending on the details of the transaction where cover will include the cost of entire transaction being set aside, additional amounts needing to be paid, interest and defence costs. Policies are for six years or the period for which a transaction can be challenged.

09 Appendix

Typical information requested from sellers to facilitate the due diligence process; this information will need to be tailored and /or supplemented depending on target size, sector and geography:

General Information

a) Legal entity structure chart outlining the perimeter of the transaction
b) Information memorandum or other documentation providing background information on the target business
c) Details of past acquisitions and divestments by the target company
d) Draft purchase agreement

Insurance Due Diligence

a) Full copies of all current insurance policy documentation and surety bonds
b) Details of any self-insurance arrangements, including captives, alternative risk-financing programmes, parental guarantees, or co-insurance or co-participation clauses
c) Details of current annual premium spend and/or internal premium recharges, together with details of other insurance programme related costs, e.g. broker remuneration, claims handling charges, engineering surveys. Information to include details or any adjustment clauses
d) Details of any significant changes to the insurance programme structure in the past five to ten years
e) Details of key customers and suppliers of the target business
f) Details of any discontinued products and/or services
g) Schedule of all premises, including full address and details of usage
h) Reinstatement value of buildings and contents (per premises), together with maximum and average stock holdings
i) Business interruption work sheet
j) Budget payroll and employee numbers, allocated between clerical and manual workers, split by site
k) Budget turnover, including a geographical split
l) Vehicle numbers split by type (commercial vehicles and private cars)
m) Financial guarantees (guarantee amount/ beneficiary/type/issuance and expiry date)
n) Schedule of top 25 debtors (name/address/ country/outstanding debt)
o) Details of key suppliers (tier 1/2), single source suppliers, service suppliers (IT, utilities etc..), bill of materials (manufacturing/ production) and critical components / lead times
p) Other exposure information, as required, e.g. last completed proposal forms
q) Minimum 5-year ground-up insurer loss runs for each class of cover noting paid and outstanding amounts; for liability classes with a high frequency of claims, a ‘triangulation’ should be requested
r) Detailed description of all major losses in last 5 years and/or in relation to any open claims

s) Declaration of any known circumstances that may give rise to a claim in the future
t) Details of any major uninsured losses
u) Insurance survey reports including details of estimated maximum loss scenarios and associated calculations, together with details of any outstanding risk improvement recommendations and site responses to these items
v) Copies of business continuity and/or disaster recovery plans

Human Capital

a) Headcount by geography
b) Details of the management team
c) Employment transfers
d) Accrued Rights Directive/TUPE
e) Collective bargaining agreements
f) Employee benefit provisions on the balance sheet
g) Employment contracts and change in control provisions
h) Local and global short-term and long-term incentive plans
i) Organisation structure, including job grading and compensation benchmarking
j) Employee benefits, including pension and perquisites
k) Pension plan documents, including actuarial valuation/reports
l) Insured employee benefit policy and contracts
m) Notice period and severance policy
n) Statutory human resources compliance
o) Employee handbook
p) Restructuring plan
q) Human Resources policies

Intellectual Property (IP)

While most of the diligence can be undertaken using data available from IP offices, proprietary databases and analytics platforms, some information obtained during the financial and operational due diligence is helpful, specifically, details of:

a) Complete schedule of IP assets against current assignees (including security assignees, charges and liens)
b) Licensing, collaboration or joint-cooperation agreements
c) Patent landscapes
d) Patent to products mapping
e) List of geographical business activities
f) List of key competitors

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