



transaction traction

Mergers & Acquisitions

The New Normal?: Recent Developments in the Use of Representation and Warranty Insurance in M&A Transactions

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Agenda

- I. Introduction
- II. Review of R&W Insurance Basics
- III. Recent Developments
- IV. Underwriting Process Pointers
- V. R&W Insurance Claims
- VI. Conclusion



Review of R&W Insurance Basics

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Review of R&W Insurance Basics

R&W Insurance (Unknown risks)

1. Representations and warranties insurance (RWI) indemnifies a party to a transaction for financial losses arising out of:

- Breaches of a representation or warranty.
- The pre-closing tax indemnity.

▶ Price range: 2.8%–3.2% +/-

Other Transaction Liability

Insurance Products (Known risks)

1. Tax insurance indemnifies the insured for taxes, interest, penalties, contest costs, and gross-up (loss) arising out of a specific and known tax issue, such as:

- S-corp status.
- Federal energy (ITC) tax credits.
- REIT status.

▶ Price range: 2.0%–6.0% +/-

2. Contingent liability insurance indemnifies the insured for losses arising from certain contingent liabilities such as:

- Successor liability.
- Fraudulent transfer/conveyance.
- Existing litigation.

▶ Price range: 8.0%–15% +/-



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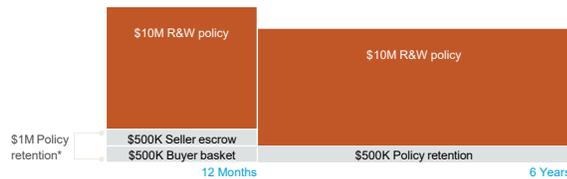
R&W Insurance Basics: Comparison with traditional indemnification structure

	Traditional indemnification coverage	Typical policy coverage
Survival or policy period	<ul style="list-style-type: none"> 12-18 months for general reps. SOL for fundamental reps. 	<ul style="list-style-type: none"> Three years for general reps Six years for tax and fundamental reps.
Indemnification cap or policy limit	<ul style="list-style-type: none"> 10-20% of purchase price for general reps. Seller escrow of such amount typically required. 	<ul style="list-style-type: none"> 10-20% of purchase price is typical (but may be able to insure up to 100%) Seller only needs to escrow 0-1% of proceeds.
Loss definition	Inclusion of consequential damages, DIV, multiplied damages, and similar damages is heavily negotiated.	Insurers are willing to follow silence with silence, as long as purchase agreement does not explicitly grant/exclude such damages.
Materiality scrape	Inclusion of single or double scrape and materiality qualifiers in reps is heavily negotiated.	Policy will follow scrape agreed to in purchase agreement (and buyer typically can get a synthetic scrape in NSI deals).
Recourse for breaches	Buyer's recourse is to proceed against the escrow, which may include proceeds owed to management/rollover sellers.	After retention is satisfied, the policy will respond to all covered matters. Buyer has right (but not obligation) to proceed against the escrow to satisfy part of the retention.



R&W Insurance Basics: Buy-side policy example

Transaction value	\$100M
Escrow	\$500K
Buyer basket	\$500K
Policy placement	Buy-side R&W policy covering general reps for three years and fundamental/tax reps for six years
Policy limit	\$10M
Policy retention	\$1M first 12 months, then \$500K
Premium	\$300K (3% of limit)



*Retention is eroded by (i) losses incurred pursuant buyer basket; and (ii) amounts recovered from seller escrow. The retention drops down after the seller escrow is released.

Buy-side vs. Sell-side policies

- Buy-side policies pay the buyer directly for covered losses
- Sell-side policies reimburse sellers for amounts paid to buyers pursuant to contractual indemnification provisions.

Buy-side vs. sell-side policies

2014	2015	2016	2017
90/10	95/5	99/1	95/5



Recent Developments

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Recent Developments: Market trends and capacity

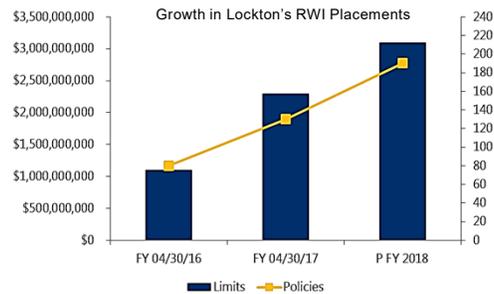
Market trends

- Cost and key terms
 - More competitive pricing (2.8-3.2% of limit) and retentions (1% of EV).
 - Diligence fees range from \$25,000 to \$45,000.
- Statistics from a key US market (2017 vs. 2013)
 - Submissions up 510% (500+ in 2013 vs. 3200+ in 2017).
 - Policies issued up 300% (90+ in 2013 vs. 400+ in 2017).
 - Premiums written up 200%.¹

¹2016 vs. 2013; 2017 premium numbers not yet available.

Market capacity

- Over \$1B from various US and foreign (UK/Lloyd's) markets
 - Current insurers include: AIG, Ambridge, AWAC, Beazley, Berkley, Berkshire Hathaway, BlueChip, CFC, Chubb, Concord, Ethos, Euclid, Everest, Great American, Hartford, Ironshore, QBE, Tokio Marine, Vale, XL Caitlin.



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Recent Developments: Trends in policy terms

- **Hot topics in the market.**
 - No seller indemnification transactions, including availability of synthetic materiality scrapes and pre-closing tax indemnities.
 - Dealing with material seller rollover amounts.
 - Availability of interim breach coverage and nil retention for fundamental reps.



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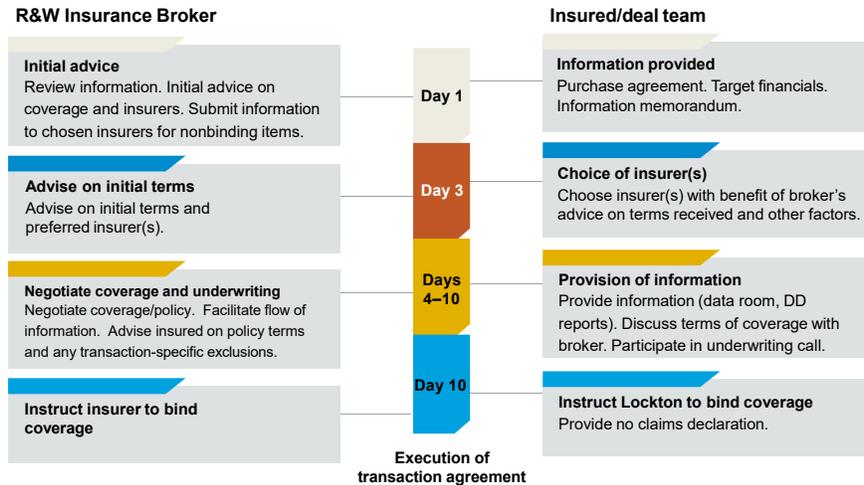
Underwriting Process Pointers

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Underwriting Process Pointers: Illustrative timeline



Underwriting Process Pointers: Best practices

- **Timing of introduction of R&W insurance.**
- **Tailoring due diligence process for the use of R&W insurance.**
- **Utilizing market experts throughout the full life cycle of the R&W insurance process.**
 - Selection of market.
 - Preparation for underwriting call.
 - Negotiation of policy provisions and deal-specific exclusions.



R&W Insurance Claims

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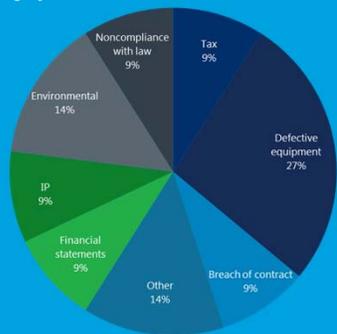


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R&W Insurance Claims: Recent claims data

Lockton statistics

Currently¹, there are 15 policies brokered by Lockton's US team with one or more open claims, which approximately breakdown by category as follows:



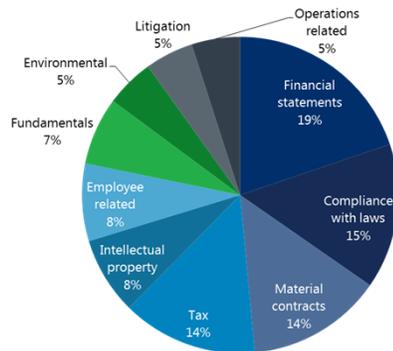
31 closed claims. Of these:

- 21% had claim payments made by insurer, and 60% of such payments were limit losses.
- 27% were within the retention.

¹As of November 2017.

AIG statistics

AIG's most recent claims report shows the following breakdown of claims on a global basis:



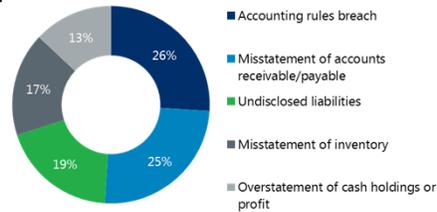
- Compliance with laws was given as the primary reason for breaches in the Americas — accounting for 19% of all alleged claims breaches.
- In Asia Pacific, financial statements and material contracts were the cited cause of almost 2/3 of R&W breaches.



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R&W Insurance Claims: Highlight on financial statements

Financial statement claims on AIG policies can be more specifically described as follows:



Source: AIG M&A Claims Overview, May 2017

- Accounting rules breaches and misstatement of accounts receivable/payable accounted for just over half of all financial statements breaches.
- The AIG study also showed that frequency of claims varies with the size of the deal, with deals \geq \$1 billion most likely to claim damages.



R&W Insurance Claims: Case study

The deal

- PE client purchased a \$5M buy-side R&W policy
- Target was a US manufacturer of precision machine plastic components that serves various industries.

The claim

- After closing, target's largest customer canceled its contract.
- Buyer alleged that such cancellation and corresponding lost revenue was the result of undisclosed contract terms, and thus the breach of such contract, by the seller — a breach of the material contracts representation.

The result

- The insured, with the help of its counsel and Lockton, worked to substantiate the claim and quantify the damages.
- Following a complex analysis including multiple contracts and breaches, the insurer agreed to pay the full limit of the policy to help cover the losses incurred by the buyer as a result of the customer canceling the contract.

Determining damages

General contract damages

- Out-of-pocket damages.
- Rescission — unwind/pay back.
- Ways to calculate value — market, income, and cost approaches.

Multiplied damages

- Consideration for the valuation methodology and impact the claim would have had on the valuation.
- Is it a one-time loss or will it flow through to recurring EBITDA?
- Valuation and forensic experts engaged to look at the industry and market at the time, among other things.

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Speaker Biographies

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Leah Coakley has been a Transaction Liability (TL) broker since early 2014 and was an underwriter at Ambridge Partners for 9 years prior. She represents Lockton clients across the US in the procurement of TL policies, which includes Reqs & Warranties, Tax, and Contingent Liability Insurance. Leah serves as a client advocate, working closely with deal teams and their counsel, in the procurement of TL quotes and throughout the underwriting, policy negotiations and claims processes.

Daniel J. Brown

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Dan Brown is a partner in the Trial Group. His practice areas include a broad variety of complex commercial litigation, including arbitration, and state and federal court litigation. Some of his areas of concentration include securities litigation, contract and intellectual contract disputes, insurance litigation, Directors and Officers liability insurance coverage issues, and litigation in the agricultural industry.

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Jonathan A. Van Horn is a partner in the Mergers and Acquisitions practice group. Jon represents purchasers and sellers in merger and acquisition transactions, including negotiated business combinations and contested acquisition transactions. Jon's experience in this area includes advising boards of directors and special committees. Resident in Dorsey's Toronto office from 2002 through 2004, Jon advises clients on U.S. law aspects of U.S.-Canada cross-border M&A transactions. Jon also advises public and private companies on general corporate matters. Jon is a member of the Mergers and Acquisitions Committee of the ABA's Business Law Section and is a contributor to the committee's thought leadership projects, including the widely consulted deal points studies.



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