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**ROUNDTABLE** September 2019

# MANAGING TRANSACTIONAL RISK

The fast pace of a transaction process means that acquirers need to be committed to identifying and assessing risks – both known and unknown – as early and fully as possible. That requires optimum effort, and engaging legal, financial, accounting, tax, insurance and other professional advisers to assist. Despite these efforts, issues may come to light after closing that were not discovered in due diligence. With shareholders increasingly aware of the risks of poor transaction execution, particularly in large, transformational deals, risk management will continue to evolve. ■

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**FW: Do you believe today's acquirers, in general, are paying enough attention to identifying and assessing risks during the transaction process? Are they falling short on particular aspects?**

**Hernández:** There is increasing pressure from institutional investors toward efficiency and lower transactional costs in the private equity (PE) industry. Liquidity in the market is provoking fierce competition among PE firms when solid companies with experienced management teams are for sale. Investors take a light approach to due diligence in order to be more competitive and less invasive during the negotiation process, particularly on aspects of the transaction such as international trade sanctions, cyber risks, compliance with laws such as the General Data Protection Regulation (GDPR) and consumer law, tax and transfer pricing matters, and environmental and health & safety.

**Reynolds:** The due diligence process for deals we insure is usually very thorough. In fact, some acquirers have found that the involvement of representations and warranties (R&W) insurance underwriters has caused them to focus on particular risks that they might not otherwise have highlighted. On the other hand, when deals are rushed or the amounts at stake are considered by the acquirer to be immaterial, buyers may skimp on diligence.

**Censullo:** In general, we see strong intent and thoughtful action in performing comprehensive due diligence, and in reviewing and confirming detailed information. There can be an initial reluctance to prioritise items viewed as immaterial, due to compressed timelines, but overall attention to detail is high. Accessing complete data can become a hurdle. Today's acquirers seem aware of emerging risks and their potential deal impact, such as cyber and data security, changing weather perils, foreign compliance and fluctuating economic risk indicators.

**McGowan:** Generally, the majority of acquirers in this market perform robust due diligence in the material areas where risk can arise. Most acquirers hire third-party advisers or have dedicated internal deal teams that perform diligence in key areas such as business and operational due diligence, industry research, financial and accounting, commissioning a quality of earnings report and obtaining detailed legal and tax diligence reports with the aid of outside advisers. PE firms are especially keen at assessing the risks to future business profitability and growth, while strategic buyers may place greater emphasis on future integration risks, obtaining business synergies and shared services. Certain challenges can arise when dealing with a target that has substantial international operations or when a deal is a carve-out involving multiple subsidiaries or assets.

**Sherman:** Generally, acquirers do a good job in risk-related diligence. However, risks are increasing in transactions as we are seeing a growing number of failures occur that a deeper risk analysis could have possibly averted. Another contemporary problem is that there is a lot of competition chasing deals, which puts pressure on time available for, and extent of, diligence in risk-related areas.

**Doran:** Due to the fast pace of the transaction process, there are areas where it would appear that acquirers are increasingly taking a 'targeted' approach to due diligence, with 'red flag, exceptions only' reporting now very much established. While this approach lends itself well to certain areas of reporting, it perhaps increases the risk of failing to identify issues in areas where a more thorough compliance assessment is required. In certain circumstances, trade buyers may be prepared to take a lighter touch approach to due diligence in certain matters, based on their knowledge of the relevant industry and associated exposures. While this approach is understandable, on an insured deal this may generate a potential challenge with regard to obtaining the desired level of coverage for such exposures.

**Rittberg:** We believe that acquirers are generally rational actors who have financial and reputational incentives to properly identify and assess deal risks. If permitted by a seller, a buyer will spend the time and money to understand what they are buying so that they maximise returns and avoid unexpected liabilities. In today's sellers' market, buyers are pushed by sellers to complete diligence more quickly, but notwithstanding time pressure and increased competition, we see buyers still complete comprehensive evaluations of target companies. The most successful buyers leverage sophisticated legal, accounting and other specialised advisers to ensure that they are up to speed on the key risks related to the business they buy.

**DeLott:** Today's acquirers, in general, are committed to identifying and assessing risks as early and as fully as possible during the transaction process. To that end, acquirers will often engage legal, financial, accounting, tax, insurance and other professional advisers to bring their particular expertise to bear in a transaction. Negotiations between buyers and sellers will often focus on allocating risks, both known and unknown. That said, despite the best efforts of buyers, things often come to light after closing that were not discovered in due diligence. Ideally, the buyer will have negotiated appropriate indemnities or M&A insurance for protection. When acquirers do fall short in assessing risk, it is usually a function of the time allowed for thorough due diligence.

**FW: What are the key areas that need to be considered as part of a due diligence process? To what extent is the scope of due diligence widening to incorporate 'non-traditional' areas of assessment?**

**Reynolds:** Key areas from an underwriting point of view are financial statements, taxes, compliance with laws, material contracts, particularly customer relationships, employee matters and intellectual property (IP). Deal dynamics are also very important. We consider who the parties to the transaction are as well as their incentives. For example, if owners

and managers are rolling over equity or continuing to work for the target following the acquisition, then they have incentive to disclose issues thoroughly to the new owners.

**Censullo:** Solid diligence must encompass all aspects of a target company, including ownership structure, financial and tax, employment matters, operations, products and services, contracts, and environmental hazards, to name a few. Cyber protection is now a constant interest. Threats against, and destruction of data, coupled with new forms of viruses, and other means of system attack and disruption, have become risky. Complexity with deal structures and prior M&A activity is widening the scope of diligence. We see high rollover percentages, IP, employee and regulatory matters, as areas getting close attention.

**McGowan:** It is important that proper diligence is performed on the business or operational risks, legal and regulatory items, and financial and tax diligence, on every transaction. A fulsome assessment should include a review of the target's compliance with law, material customers and contracts, financial and accounting data, labour or employment issues and a detailed tax analysis. In particular, obtaining a comprehensive financial statement analysis which includes a quality of earnings report and net working capital analysis allows a buyer, and ultimately an insurer, to gain insight into the quality of the target's earnings, revenue recognition policies and its asset and liability makeup.

**Sherman:** Aside from the standard and typical due diligence areas of consideration like the target's financial results, tax or legal risks, certain industries present specialised, different and heightened issues that require an enhanced due diligence focus to minimise the risk to the buyer. For example, although applicable to all industries, today there is more focus on cyber risk than traditionally in the past.

**Doran:** Typically, a buyer would carry out, as a minimum, financial, tax and legal due diligence in respect of the target, with the latter encompassing areas such as corporate, banking, key contracts, regulatory, employment and pensions, IP, IT and data protection, litigation and real estate. Depending on the nature of the business, a buyer may also commission technical, commercial and environmental reports. Recently, on certain businesses where IT infrastructure and personal data is material to the business, we have seen acquirers expand due diligence to include a technical audit of the target's IT to assess cyber risk and data protection compliance, as well as the integrity of the infrastructure itself.

**Rittberg:** We see acquirers evaluating corporate, labour and employment, tax, IP, environmental, regulatory and other industry-specific risks in diligence processes. We also frequently see buyers complete customer and industry diligence and litigation and insurance diligence as part of comprehensive due diligence processes. We are seeing deeper dives into technology and security risk related to cyber threats and continued focus on whether companies are properly protecting personally identifiable information and other data.

**DeLott:** In addition to the traditional areas of due diligence, such as legal, financial, accounting, tax and insurance matters, there is also an emphasis today on a target company's exposure to cyber intrusions. Does the target have adequate resources in place to protect the company, its customers and other counterparties from a cyber attack? Does the company have adequate cyber insurance in place to protect in the event of a cyber attack? Other 'non-traditional' areas of assessment include human resources issues. Does the company have a history of treating all of its employees, including women and members of minority groups, appropriately and respectfully? What procedures are in place to ensure compliance with company policies in this area?

**Hernández:** The key areas that need to be considered during due diligence will depend on the profile of the target business. For instance, if the target is a FinTech business, potential acquirers will focus their due diligence analysis on IP and IT regulatory aspects, as well as material contracts. However, if the target company is an industrial business, bidders will focus on employment and health & safety aspects, compliance, tax, permits and licences. In some cases, we are starting to see transaction teams taking a more cautious approach on tax and compliance with laws and regulatory aspects.

"IN SOME CASES, WE ARE STARTING TO SEE TRANSACTION TEAMS TAKING A MORE CAUTIOUS APPROACH ON TAX AND COMPLIANCE WITH LAWS AND REGULATORY ASPECTS."

MIGUEL ÁNGEL HERNÁNDEZ
Tokio Marine HCC

**FW: In your experience, what are the most common post-acquisition issues that tend to arise after closing, that could have been detected or avoided during the due diligence process?**

**Hernández:** There are two post-acquisition issues that can be mitigated or avoided with good due diligence. The first is regulatory tax risks. Significant problems arise throughout the deal process when buyers fail to understand regional and industry-specific requirements. It is key to anticipate regulatory issues during the opportunity stage of a deal, and further support this exercise with robust due diligence during the deal investigation phase. The second issue is that misunderstanding the market opportunity can cause significant setbacks once the deal finalises. Mitigating this risk during the investigation phase is highly recommended as this covers the target and its business practices.

> THE MOST COMMON POST-ACQUISITION ISSUES INVOLVE A FAILURE BY THE SELLER TO HAVE MADE APPROPRIATE WRITTEN DISCLOSURES TO THE BUYER CONCERNING PROBLEMS WITH THE BUSINESS.
>
> STEVEN R. DELOTT
> Simpson Thacher & Bartlett LLP

**McGowan:** While it is always difficult to fully assess issues that can arise during the integration of a target's operations into the buyer's business, especially in the case of strategic buyers or platform acquisitions, some of the most common problems involve the following: contract disputes with customers or suppliers, key employee or management retention issues, IT integration and post-closing tax treatment. For carve-out transactions, there are also increased risks that shared services between the buyer and seller will be insufficient or that additional incremental costs could result from unforeseen infrastructure upgrades or key new employee hires when it was represented that the assets being purchased were sufficient for the business to perform in the ordinary course. Effective planning for integration well in advance of closing, and performing adequate due diligence into these key operational areas, can help mitigate the risk that a deal is non-accretive or unsuccessfully integrated.

**Doran:** While it is difficult to generalise around the most common post-acquisition issues, it seems likely that the ongoing trend toward a lighter-touch due diligence process on a truncated timeline will result in an increased number of post-transaction issues. On the basis of claims data on insured transactions, the most frequent areas where issues arise are accounting and tax matters, which acquirers and their advisers simply do not have the time or the opportunity to identify and address prior to closing.

**DeLott:** The most common post-acquisition issues involve a failure by the seller to have made appropriate written disclosures to the buyer concerning problems with the business. It would be impossible to eliminate all instances of inadequate disclosure, but the seller should have an incentive to make the effort to prepare proper disclosure schedules. In today's hot M&A market, many acquisition agreements are signed without the buyer having any recourse against the seller for having delivered what turns out to have been inadequate disclosure schedules.

**Rittberg:** The vast majority of inaccuracies result from errors or omissions in the disclosure or diligence process. Some of the largest claims stem from breaches related to financial statements or undisclosed liabilities. Sometimes internal communications or technology issues can cause a breach of representation and perhaps diligence could have identified the issue before closing. But other times breaches come from completely unknown and unexpected items, such as third-party claims that could probably not have been anticipated by due diligence. In the most troubling cases, fraud within a target business can cause post-acquisition issues and in those cases, we and the insureds would consider prosecuting the bad actor that caused the loss. Fraud is unfortunately sometimes difficult to discover in diligence if the fraudulent party has covered their tracks.

**Censullo:** Hindsight is 20/20 and even with deep due diligence, unexpected issues arise. The current, extremely active and dynamic global M&A marketplace is driving a relatively new problem: managing change. Common, post-close issues arise from activities in aligning company and owner, employee role changes, the merging of financial and operational systems, cultural shifts and overall understanding of the strategic direction of the company. For example, the combining of add-on entity financials into a buyer's accounting system can create vulnerabilities if knowledge of systems that have been modified or customised is not obtained, resulting in flawed revenue or earnings.

**Reynolds:** Lost customer claims occur frequently. The intent of an R&W policy is not to cover all lost customers – only situations where a seller knew there was a serious problem and did not disclose it. This is a difficult issue with regard to diligence. The seller is often reluctant to allow the buyer to contact its customers until they are confident that the deal will sign. Customers can terminate the relationship for any number of reasons, including the acquisition itself. Ultimately, lost customers are a risk of doing business and are often offset by gains of new customers. Nonetheless, the more carefully a buyer assesses the strength of the target's customer relationships, the more likely it is that the acquisition will be successful.

**Sherman:** The post-acquisition issue that we see arising most frequently in recent transactions is the acquirer's discovery of problems with major customer relationships. Second to that is the post-acquisition discovery of unreserved excess or obsolete inventory that existed at closing.

**FW: What key advice would you offer to acquirers when it comes to negotiating representations and warranties with the seller?**

**McGowan:** Among the most important factors to consider as a buyer when entering into a transaction and negotiating R&W are, first, having a dedicated deal team to 'quarterback' the deal. Second, companies must hire the right advisers or have an experienced internal team to diligence the material areas of each deal. Third, companies must perform all steps in a timely manner, which includes conducting diligence and engaging an insurer as early as possible in the transaction. Fourth, companies must focus on the truly material issues during negotiation. Fifth, companies must negotiate special indemnities with the seller for any material known issues that are discovered.

**Sherman:** Be thorough and tie the type or details of the reps to the specific characteristics and risks of the business you are buying. Too often, reps are based on boilerplate language and, as a result, the nuances of the operations and the transaction are not covered.

**Rittberg:** Acquirers should work closely with their counsel and specialists to obtain a comprehensive suite of representations and warranties to match up with the key risks for the target business and to address any issues identified in due diligence. The R&W and related disclosure should be clear and specific enough to paint an accurate picture of the business the buyer is buying. From the insurer perspective, acquirers will not ask sellers to make representations that amount to guesses about the future or how the business will perform going forward. For instance, representations about retaining customers after a deal closes or collecting receivables within a certain time frame in the future are not something that a seller can know when the deal closes. Insurance will also not cover R&W about known issues such as an open litigation or an ongoing environmental clean-up. For known matters, we advise buyers to address them with the seller in the purchase price or through a specific indemnity in the acquisition agreement.

**Doran:** Negotiation of all aspects of a deal will, of course, be primarily a balance of bargaining power between parties. In respect of R&W, it is worth considering their primary purposes: risk allocation and disclosure of information. Both these factors will be reflected in the breadth and strength of R&W from a buyer's perspective, and will, to some extent, be a function of the commercial position of the parties. From a buyer's perspective, even where the balance of bargaining power necessitates a compromise position on the financial liability accepted by the seller for breach of warranty, it is worth focusing time and effort in the negotiation of those warranties which are truly material to the value of the target business, with a view to driving meaningful disclosure. For example, on a transaction involving the sale of a software company, it would seem advantageous to negotiate additional warranties regarding IP and IT matters, rather than expend commercial capital negotiating detailed real estate warranties. Similarly, it seems likely to be the case that detailed warranties regarding value-critical areas of the business are more likely to be accepted by the seller where the proposed drafting is balanced and meaningful.

**DeLott:** The key to negotiating R&W is to understand what risks are most material to the business and to focus negotiations around those issues only. There is no

> “R&W INSURANCE HAS EXPLODED IN USE DUE TO THE AGGRESSIVE NATURE OF TODAY'S M&A MARKET.”
>
> JOANNE R. CENSULLO
> Risk Strategies

reason to require an overly aggressive representation or warranty for issues that do not materially impact deal value. Moreover, sellers are often more receptive to providing fulsome R&W when the indemnification exposure is capped at a reasonable level. When M&A insurance is part of a transaction, the seller's indemnification obligation is eliminated or dramatically reduced, with the insurer serving as indemnitor.

> ALTHOUGH MORE POLICIES ARE BEING WRITTEN WITHOUT SELLER INDEMNITY, BUYERS SHOULD BE CAREFUL ABOUT AGREEING TO SUCH TERMS.
>
> ROY REYNOLDS
> Great American Mergers & Acquisitions

**Reynolds:** The seller is the party to the transaction most knowledgeable about the target business. If the seller is not motivated to make thorough and accurate disclosures, then the risk of an unsuccessful acquisition is greatly increased. R&W insurance is a great tool for protecting against unknown circumstances that result in breaches. However, if the seller does not make a good faith effort to thoroughly disclose known risks, a buyer is likely to be exposed above the policy limit. Although more policies are being written without seller indemnity, buyers should be careful about agreeing to such terms. An R&W insurance policy often covers around 10 percent of the value of the target company, but the buyer purchases the entire company.

**Hernández:** I would encourage transaction team members to conduct a thorough disclosure exercise in the context of an arm's length negotiation of the sale and purchase agreement (SPA) and warranty catalogue. Knowledgeable legal and tax advisers should be involved in such negotiations at an early stage. It is also important to carry out detailed due diligence to assess the correct value of a business and the risks associated with buying it. In this context, the existence of M&A insurance can ease the negotiation process, bringing strategic benefits to both the buyer and the seller.

**FW: Are you seeing an increased adoption of M&A insurance to help manage risks and see deals through to completion? Could you outline some of the trends you are seeing in M&A insurance offerings, with regard to policies, coverage, terms, pricing, and so on?**

**Rittberg:** The biggest increase in overall volume of M&A insurance occurred in the last three years. Key trends that have led to increased use of the product include improved definition of 'loss', more efficient and reliable underwriting process, and lower rates and retention. Importantly, the industry has demonstrated that insurance offerings can respond appropriately when it matters.

**Doran:** We are seeing a continued increase in the number of M&A policies placed at a year-on-year growth rate of 20 to 30 percent, depending on the relevant region of the world. In certain markets, notably in Europe, downward movement in pricing and retention appears to have slowed somewhat, although in other markets, notably Asia Pacific with historically higher rates, pricing and retention, continues to experience strong downward pressure. In terms of coverage, the general trend continues to be in the direction of increasingly broader coverage, with certain insurers and underwriters offering the ability to remove certain exclusions historically seen as standard in the market.

**Reynolds:** Adoption of M&A insurance has increased dramatically in recent years. Broader coverage with fewer exclusions, lower retentions and lower pricing have made it a very desirable product for clients – both to manage risk and to free up capital from escrow. With more insured-friendly terms and conditions, industry losses have begun to increase. As losses develop, the industry will see whether these trends are sustainable.

**Hernández:** According to recent articles about M&A insurance produced by M&A brokers and lawyers, warranties & indemnities (W&I) insurance is used in no more than 25 percent of European corporate deals and in around 40 percent of corporate real estate transactions. Similarly, in the US, the overall market penetration for W&I insurance is between 15 and 20 percent. In terms of the trends we are seeing in the M&A insurance offering, we have seen an increase in underwriting capacity with premiums and deductibles continuing to drop while coverage positions are being enhanced. Lowering retention levels, the major trend in the European W&I market over the last 18 months, has been the result of 'nil retention' structures – no self-insured retention in the SPA which first came into the market from real estate transactions. Also notable is the increased claims activity on W&I policies over the last 18 months.

**Censullo:** R&W insurance has exploded in use due to the aggressive nature of today's M&A market. The seller's upper hand over the buyer's eagerness to invest capital has driven bid terms into unprecedented areas, with popular 'seller walkaways' leaving buyers with little or no access to indemnification. The opportunity to protect themselves through insurance is a welcome relief for negotiating parties. Furthermore, opportunistic insurers and the capacity they bring to the marketplace have pushed R&W to new levels, driving some US premiums to 2.5 percent of purchased limit and retentions under 1 percent of equity value. Coverage terms continue to expand. Interim breach coverage has entered the market on selected deals. Recent specific changes in underwriting appetites are found with nature and size of deal, interim breach coverage, severability of shareholders with large rollover percentages and allocation of loss, definitions of key terms such as fraud and subrogation, and pre-exclusivity.

**DeLott:** We now see M&A insurance on every deal in which either the purchaser or seller is a PE firm, and on an increasing percentage of deals in which the purchaser is a strategic buyer. The 'sweet spot' for the use of M&A insurance is deals valued between $500m and $2bn. As the number of carriers that provide M&A insurance has grown, there is tremendous competition on both price and coverage terms. It is a buyers' market for M&A insurance. As of the summer of 2019, the rate on line – the premium cost per dollar of insurance – is around 2 to 2.5 percent and even less on particularly large transactions.

**Sherman:** There has been a significant and steady increase in the absolute number of R&W insurance policies written over the past several years, including a large growth in the percentage of deals completed that have been covered with R&W insurance. In particular, private equity buyers were using it only sporadically in the past where it has become commonplace today. Coverage generally varies by industry, buyer and other transaction particulars, but we are seeing higher levels of coverage than in the past. It is unclear whether the increase is the result of larger deals or a willingness to pay higher premiums for larger limits because of more confidence in the product.

**McGowan:** There has been an increased adoption of M&A insurance over the last five or six years and the industry as a whole has experienced tremendous growth during that time. It has been estimated that approximately 35 percent of all deals in North America now utilise R&W insurance and the utilisation rate is closer to 75 percent for private equity and financial sponsor deals. We have also seen a large uptick in the number of strategic acquirers utilising insurance as risk managers and highly acquisitive corporations with dedicated deal teams continue to compete against PE firms in auction processes and also obtain increased comfort with the product as claims are paid out.

> PARTIES TO A DEAL ARE MANAGING RISKS AND FACILITATING DEALS BY SHIFTING THOSE KNOWN AND UNKNOWN LIABILITIES TO THE INSURANCE MARKETS INSTEAD OF LEAVING MONEY IN ESCROW OR OTHER INDEMNIFICATION STRUCTURES.
>
> JAY RITTBERG
> Euclid Transactional

**FW: How are parties involved in a deal using R&W and tax insurance policies to facilitate transactions and manage the residual risks?**

**DeLott:** R&W insurance policies and tax insurance policies serve two different purposes. Parties involved in a deal use R&W insurance to cover unknown risks, rather than attempting to allocate risk between themselves. Tax insurance policies are used to cover known risks – the risk that a tax authority will challenge a tax position historically taken by the target business. Both of these products facilitate transactions by streamlining negotiations between buyers and sellers around R&W, indemnities and survival periods. Instead of the buyer and seller wrestling over risk allocation issues for an extended period of time, an insurance policy will be used to outsource the risk.

**Rittberg:** Parties to a deal are managing risks and facilitating deals by shifting those known and unknown liabilities to the insurance markets instead of leaving money in escrow or other indemnification structures. R&W insurance can free up buyer and seller capital by protecting them from loss that was unknown at closing, such as a violation of law or an unknown breach of customer contract. Tax and other contingent insurance can facilitate deals by shifting specific identified risks over to the insurance markets. By removing known issues, like a specific identified tax treatment, from the list of deal risks, insurance helps deal parties bridge the gap over who should be responsible for that matter.

**Censullo:** R&W and tax liability provide a supplemental solution for buyer and seller

for both unknown and known issues such as tax interpretation, which are otherwise difficult to negotiate through and could hinder the deal. These products provide a comfortable alternative to historical risk assumption through risk transfer to an insurer. There is a specific process for negotiating coverage and fitting key points into a developing deal, whether it is IP, a family business issue or product warranty. Ultimately, the transaction agreement and policy form should reflect the parties' agreement of who is assuming what risk.

> "THERE HAS BEEN AN INCREASED ADOPTION OF M&A INSURANCE OVER THE LAST FIVE OR SIX YEARS AND THE INDUSTRY AS A WHOLE HAS EXPERIENCED TREMENDOUS GROWTH DURING THAT TIME."
>
> MICHAEL MCGOWAN
> AXA XL

**Sherman:** Sellers today are frequently requiring acquirers to buy R&W insurance for a specified amount in order to conclude a transaction. Especially where transactions are initiated through an auction, sellers are frequently requiring bidders to commit to buying a policy in order to even participate in the auction process. Having the policy allows the seller to reduce the indemnities to the buyer, reduce the amount of escrow holdback and eliminate some of the restrictions on escrow release.

**Reynolds:** Tax insurance policies are often used to take known tax risks off the table. Buyer and seller may well see the quantum of the risk differently. Rather than negotiate a value among themselves, they can purchase a dedicated policy that places the risk on the insurance company. The price of the policy can then be built into the purchase price. R&W insurance is particularly valuable to PE funds because it covers residual risks, and enables them to increase their internal rate of return and distribute deal proceeds to their stakeholders. Corporate buyers, too, are increasingly adopting the product. Using R&W insurance allows strategic buyers to reduce their demand for escrow and make their bids more competitive with sellers.

**McGowan:** Both R&W insurance and tax liability insurance can help a buyer manage the risks associated with making an acquisition. These policies often coexist, providing a buyer with fulsome coverage that applies to unknown liabilities that existed at the time of the signing of the transaction or during a pre-closing tax period, typically covered in an R&W policy, and also after a transaction to the extent a buyer requires coverage for specified, identified tax risks which could result from the IRS taking a detrimental tax position. R&W insurance helps facilitate a transaction and smooth out negotiations as well as either reduce the escrow or provide a clean exit for a seller in a 'no seller indemnity' transaction. On the other hand, tax liability insurance is designed to address specified known issues that can arise and protects a buyer from loss that could result from the applicable tax authority deeming the buyer to have a greater tax liability. It can also be utilised to cover issues such as renewable energy tax credit investments, the tax treatment of a spin-off or divestiture, real estate investment trust (REIT) status, S-Corp status, or the usability of net operating losses in a deal.

**Doran:** R&W, tax and contingency risk insurance solutions can be used strategically to improve a bid, allow sellers to achieve a clean exit or simply remove a roadblock from a transaction. In a competitive auction, a buyer can advance a bid proposal whereby the seller retains only very limited liability – both as to quantum and to time period – in order to distinguish itself from rival bidders requiring a traditional liability package under the warranties and tax covenant. On the sell-side, sellers are able to use the product, normally placed with the buyer, to cap their liability at a low level, and potentially nil on certain low-risk transactions, thus facilitating a clean exit.

**FW: If an acquirer purchases an R&W policy to insure the breach of the representations made in a purchase and sale agreement, and believes that a breach has occurred, what is the typical process to work with the insurance carrier to resolve the claim?**

**Censullo:** A R&W policy includes specific language on actions to be taken when the named insured becomes aware of a breach. The claims process is quite detailed and its lifecycle for resolution is based on the nature of the claim, information available and alignment of parties. The due diligence work completed on the front end and the policy language are key. Generally, timely reporting, responsiveness and the following of policy requirements should guide all breach claims handling. The first step is for prompt notification, including proof of loss to the insurer, either directly through counsel or insurance broker, via email and hard copy, with copies to the insureds' representatives. From there, the insurer will acknowledge receipt and eventually prepare a response, typically in the form of a reservation of rights letter. The named insured typically assumes the duty to

defend, and is responsible for the claim activities, subject to compliance with policy language and consent around notification, investigation, defence, settlement and recovery. Subrogation is typically limited to cases of fraud.

**Reynolds:** The acquirer should notify the insurer as soon as it believes a breach has occurred. It should provide a proof of loss, identifying the breach and the damages arising from the breach. Once a clear proof of loss is received, the claims process can move in a timely manner.

**DeLott:** Typically, the process starts with a review of the policy and those provisions setting forth the process for making claims. Certain carriers use a prescribed form of claim notice that is appended to the policy as an exhibit. The acquirer, with the help of its counsel and insurance broker – and depending on the nature of the claim, perhaps its accountants or other advisers – will provide an explanation of the breach, identifying the specific representations that have been breached, and include any supporting documentation. Upon receipt of a claim, an R&W insurer will often request an initial call with the buyer in order to further discuss the claim and to ask preliminary questions. The insurer will then respond to the claim in writing within the time period set forth in the policy, often 30, 45 or 60 days.

**McGowan:** Typically, the claims process is laid out in detail in the policy and should begin with a claim notice to the insurer as soon as an acquirer becomes aware of an issue that could result in a breach of a rep or warranty. It is critical for an insured to provide as much detail as possible when noticing the issue in order to allow the carrier to adequately assess whether or not a breach has occurred, and to quantify the damages being claimed. Timely and effective communication is of paramount importance in ensuring that claims are handled and paid as quickly as possible. Buyers should always keep in mind that there is potential for an information disparity between themselves and the carrier and it is therefore vital to incorporate detailed information in the very first notice, while also copying the original broker and underwriter to aid the process.

**Doran:** While it is tough to identify a ‘typical process’ given that each claim is so fact specific, as a general matter the process would involve an initial notification by the acquirer – as the insured under the policy – to the insurers of the breach. It is important that this is done in a timely manner in order to comply with the requirements of the policy and to preserve the rights of the acquirer under the policy. The acquirer and its advisers will then gather information around the breach sufficient to demonstrate that a breach has occurred, together with a calculation, and evidence, of the loss suffered as a result of that breach.

**Hernández:** First, the insured must establish a breach of an insured warranty. Second, it is important to clearly frame a claim which proves that none of the exclusions under the policy apply. Third, it is advisable that the insured consults with an expert over evidence of the loss suffered. Finally, the insured must notify, investigate and present its claims to the insurer in a focused and structured way to maximise the chance of a full recovery of the loss.

**Sherman:** First, the insured needs to notify the insurer as soon as they know that there may be a breach and possible claim. Following the notice submission, the insured should provide the insurer with a detailed description of the events and facts that they believe caused the breach, and if possible, the estimated amount of the loss sustained and the calculation of how the amount of the assumed loss is derived. This description should be accompanied by whatever supporting source documents and information support the claim. The insurer will review the material and follow-up, if necessary, with additional inquiries if it thinks more support is prudent to explain or support the claim. With the information provided, the insurer will be able to make a determination of whether the information supports the conclusion that a breach has occurred and the amount of loss sustained.

**Rittberg:** We generally see two types of claims: first-party claims, where the buyer claims loss resulting from the acquired business not being in the condition represented by the seller, which is common in financial statements-related claims, and third-party claims, where the buyer claims loss related to a liability or obligation owed by the acquired business to a third party, like a litigation matter. For both types of claims, facts and circumstances are examined to learn what happened

> “HAVING A DEDICATED CLAIMS TEAM WITH A WIDE KNOWLEDGE OF THE M&A TRANSACTION PROCESS AND A FAMILIARITY WITH THE ISSUES WHICH MIGHT RESULT IN A BREACH OF WARRANTY IS ESSENTIAL TO SERVICING CLAIMS.”
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> JEFFEREY DORAN
> Ambridge Europe Limited

and then work to determine whether a representation was breached and, if it was, what loss arose from that breach. Frequent and clear communication allows for the investigation of claims and to efficiently make determinations.

**FW: How important is claims experience when it comes to handling aspects such as frequency, severity and specific types of breaches, for example?**

**Reynolds:** Customers buy insurance to protect against financial loss. In this specialised area, it is important to understand the coverage and how losses should be calculated. Claims specialists help to ensure timely and thorough claims investigations and processing.

> EXPERIENCED CLAIMS PROFESSIONALS CAN HELP MAKE THE EXPERIENCE MORE USER-FRIENDLY AND FOCUSED. IT IS ALSO LIKELY THAT EXPERIENCED CLAIMS PROFESSIONALS HAVE DEALT WITH SIMILAR CLAIMS OR CLAIMS IN THE SAME INDUSTRY.
>
> MARC SHERMAN
> Alvarez & Marsal Disputes and Investigations, LLC

**Sherman:** Experienced claims professionals can help make the experience more user-friendly and focused. It is also likely that experienced claims professionals have dealt with similar claims or claims in the same industry. These experiences help promote a quicker and more informed claim investigation process and result.

**Hernández:** With claims experience comes greater familiarity with policy wordings, the way the product works and client needs. Claims experience also assists with identifying further details likely to be required to reach a coverage determination, which helps to ensure important information is requested early on in the adjustment process. Through claims experience you are also able to build up a trusted international network of lawyers, accountants and other experts. W&I claims can involve a range of different technical accountancy, legal compliance, contractual, regulatory, employee, IP and other issues in many different jurisdictions. Therefore, having such a network of advisers is vital to ensuring claims are dealt with fairly and efficiently. Accounting expertise is also often essential to ensuring the quantum of the loss can be properly assessed and that the issue of quantum does not become contentious. This is particularly the case for severe losses.

**McGowan:** For a carrier, having dedicated claims representatives and a solid rolodex of experienced third-party legal or financial advisers on-hand is very important for proper claims handling. It is essential that everyone involved in the claims process on an R&W policy is well-versed in both M&A and the commercial approach to handling these claims and what information should be shared. Given that the transactions themselves and the claims process in M&A insurance tend to be on expedited timelines and can be extremely nuanced or complex, experienced individuals should be involved from the onset at both the carrier level and with regard to outside advisers where necessary. It is also particularly helpful for the original underwriter to be involved to help guide the claims representatives during the documentation exchange and bring them up to speed with any issues that may have already been discussed during the deal itself.

**Doran:** Having a dedicated claims team with a wide knowledge of the M&A transaction process and a familiarity with the issues which might result in a breach of warranty is essential to servicing claims. Time is always of the essence when dealing with claims and especially with third-party claims. Having a level of familiarity is critical in order to move things along quickly and provide the insured with a detailed response in a timely fashion.

**DeLott:** It is in the buyer's interest to include the participation of an experienced claims professional early in the process to review the claim, so that any deficiencies can be addressed prior to submitting the claim to the insurer. Claims experience is also a factor in choosing M&A insurance over a seller indemnity. Insurance companies, unlike sellers of businesses, are in the business of handling claims and have every incentive to pay claims fairly and promptly. The market for M&A insurance is based on confidence that legitimate claims will be paid. Carriers that develop a reputation for being overly difficult in the claims process would not last long in the business of selling M&A insurance.

**Rittberg:** An experienced claims team is critical to properly understand and handle claims. Claims teams work closely with underwriters involved in issuing the policy to make sure that the policy will respond appropriately. Over the course of reviewing hundreds of claims, a claims team becomes more efficient and gains familiarity with claims in different sectors, which helps responsiveness and thoughtfulness on claims. A collaborative claims process allows for better informed decisions on process and direction on claims.

**Censullo:** Claims experience is extremely important. Considering that R&W is a relatively young product, claims experience is just starting to provide meaningful insights with wide interest in its impact. Based on latest insurer-provided information, breaches can stem from an overstatement of assets, understatement of liabilities, failure to accrue for self-insured benefit plans, violation of codes or simple operational disconnects. Breaches of financials lead the way in both frequency and severity. The data so far is showing that larger claims stem from larger deals, those in the $500m to $1bn range. Claims professionals who are building expertise through the handling of R&W claims are indeed a valuable asset.

**FW: What are the benefits of establishing a dedicated deal team to oversee the process and ensure it runs smoothly and efficiently? In what ways can this reduce overall risk?**

**Sherman:** Having a dedicated deal team provides structure and accountability to the due diligence process. Without that structure and accountability, there is a greater chance that one or more risks inherent in the transaction are overlooked, ignored or underestimated by the process.

**DeLott:** Having a dedicated deal team is the most efficient way to execute a transaction. The deal team can bring in other resources as necessary. Using a dedicated deal team to manage transactions is particularly beneficial for acquirers that pursue transactions on a regular basis. A dedicated deal team often can 'parachute' into a transaction with established procedures for due diligence and negotiation techniques. Using a dedicated deal team also provides upper management with the ability to focus on other matters, such as running existing operations, without getting into the weeds of a deal. The deal team can seek input and authorisation from upper management as necessary.

**McGowan:** Having a dedicated deal team to 'quarterback' the transaction is vital to ensuring a smooth and effective process. Every M&A transaction brings with it a variety of challenges and the speed and tempo of these deals can certainly be chaotic at times, especially without a lot of foresight and proactive preparation. Dedicated deal teams can better leverage their experience from earlier transactions in order to learn from past difficulties and save valuable time and energy, without duplicating efforts. An experienced team is better able to manage advisers in the various specialist areas and incorporate their already established procedures for coordinating due diligence, drafting policy terms and negotiating against a seller.

**Doran:** A dedicated deal team brings a number of significant benefits to the M&A process, notably around consistency and quality of decision making. Where it is possible for the same deal team to run a repeat process in respect of a number of acquisitions, further benefits arise through the ability of the team to refine and enhance the process, by learning from issues which have arisen in the past and resulting level of expertise.

**Censullo:** In terms of overall risk reduction, experience is the greatest teacher and there is no better asset in a transaction than a well-oiled due diligence team who are knowledgeable, aligned and motivated to go the distance. Transferable knowledge, gained from experience, gets accumulated, shared and applied, allowing a team to work together effectively to achieve a high level result. Having a deal team with familiarity of the transaction process, timeline and 'how tos' around accessing and reviewing information, not only simplifies the logistics, but allows time to focus on the core objective and ensures overlooked areas are minimised.

**Rittberg:** Having a dedicated deal team to oversee the diligence processes helps with communication across diligence areas and reduces redundancy and overlap in the process. A dedicated deal team can learn from experiences on prior deals and likely has deep industry-specific knowledge to identify and address risks in the acquired business.

**Hernández:** Having a knowledgeable and dedicated team to oversee different workstreams is necessary to avoid any execution risk during the transaction process. It is also important to have a structured and skilled transaction team capable of handling all areas of expertise while considering the profile of the target business.

**Reynolds:** Most acquisitions have a dedicated deal team. It is essential to have a small group of qualified people overseeing the process. Particularly for corporate, strategic acquisitions, some of the managers may not have much experience in conducting due diligence, so it is important to have a team of experienced M&A professionals guiding their efforts.

**FW: Could you provide an insight into the additional challenges that often arise when managing transactional risk in the context of a cross-border deal?**

**Doran:** Managing a cross-border deal brings a number of challenges, most notably an instant and inherent increase in the number of 'moving parts' involved in the deal – the potential need to coordinate with multiple advisers across multiple time zones being the most obvious issue. Differing cultural and procedural expectations around deal making and risk allocation may be relevant. For example, certain legal devices around disclosure and the calculation of loss that are common in European deals would be unfamiliar to many US purchasers, and vice versa.

**Hernández:** While cross-border transactions can generate new market opportunities, they often bring heightened risk and a range of challenges. To successfully navigate through cross-border deal negotiations, it is important to understand and prevent potential risks. I would highlight two main risk subgroups: pre-deal and post-deal transaction risks. Pre-deal transaction risks include regulatory and tax challenges, valuation

issues, availability of finance and cultural differences. Post-deal transaction risks include political and economic instability, challenges of integrating the new business, losing key talent, stakeholders not supporting the acquired business and management issues.

**Rittberg:** Deal practices and documentation varies across jurisdictions. Some jurisdictions have deal structures where it is more of a buyer beware regime that protects sellers from liability, so long as they have shared documents and information with the buyer in any form. In other jurisdictions, such as the US, buyers can hold sellers responsible for loss unless the seller has specifically disclosed the risk to the buyer as a schedule to the acquisition agreement. Jurisdictions also have differing views of the types of loss and remedies available to a buyer. Beyond documentation, due diligence practices vary across jurisdictions. To appropriately manage transactional risk, it is important to understand theses differences and any insurance policy should carefully match up with the deal and legal and regulatory framework for that jurisdiction.

**McGowan:** Some of the major challenges that arise in the context of cross-border deals include the differences in local law and regulations, cultural issues with integration, country-specific labour and employment concerns and the varying tax rules and regimes that exist from jurisdiction to jurisdiction. Acquirers should take precautions when deciding whether or not to conduct local due diligence for transactions with material business operations in international jurisdictions in order to avoid gaps in the diligence that could lead to exclusions in the policy. The general rule of thumb when conducting international due diligence is that if the buyer themselves would not be comfortable taking on a risk without either properly vetting it with local assistance and obtaining a special indemnitee from the seller for any perceived issues, the carrier also will not likely be able to gain comfort.

**DeLott:** Cross-border deals bring additional challenges, including differing practices with respect to management compensation, varying legal landscapes and tax issues. Cross-border deals also require an appreciation for differences in customs and mores. Will taking an aggressive stance in negotiations cause a deal to collapse? How quickly can your counterparty be expected to move in a transaction? What level of consultation is required within a foreign company? Are key executives at the target company typically ‘on holiday’ for the entire month of August? Are there political issues at play? Would certain business practices that are considered ‘normal’ in the domicile of the target company be deemed to be illegal corruption in many Western countries?

**Reynolds:** Cross-border deals involve different business, regulatory and cultural environments. These differences can present additional challenges to even the most sophisticated deal team. Transfer pricing can also present complex tax risks.

**FW: How do you expect transactional risk management to develop in the years ahead? What changes do you anticipate in attitudes, strategies and techniques?**

**McGowan:** While the M&A insurance industry as a whole is substantially more mature than it was a few years ago, we expect that there will continue to be an incremental uptick in both the percentage of transactions that utilise the product, as well as the amount of capacity available. Market capacity is now at a point where more than $1.2bn in limits are available, making R&W insurance a viable solution on nearly any transaction size. While private equity buyers are already well-versed in the coverage, there is a lot of runway for growth with strategic or corporate acquirers as more risk managers and internal deal teams become more comfortable with the coverage.

**Doran:** We expect to see a continued focus on efficient and timely due diligence processes, as transactional participants seek to move to identify and close deals as quickly as possible. As regulations tighten and regulators seek to exercise wider enforcement powers, we expect the trend of acquirers commissioning ‘specialist’ due diligence workstreams – cyber due diligence, for example – to accelerate. We also expect the increased use of M&A insurance products to continue at a rapid rate, with the most marked growth manifesting itself in the use of specific risk products, as acquirers and advisers become aware of bespoke and sophisticated insurance solutions which remove the need for traditional risk allocation devices.

**Rittberg:** Transactional risk management and insurance will continue to gain popularity in the years ahead, particularly with strategic corporate acquirers. The insurance has grown by proving itself to be an effective tool for removing risk from deals and allow parties to walk away with more cash. The process on both the underwriting and claims sides will continue to get more efficient and consistent. Additionally, the insurance industry will likely continue to find ways to address specific known issues on deals to help dealmakers bridge the gap in risk perception.

**Censullo:** R&W insurance and other transactional products fill a need and are expected to continue to support M&A transaction activity. As deal contracts become more complex and claims experience develops, the underwriting offerings will indeed evolve, as will the products, but they have already proven their value. We do see insurers establishing specific criteria and becoming selective as their appetites respond to loss experience and competition. Whether it is found in the type or size of risk, the threshold for retention and coverage offering, each deal is underwritten on a case-by-case basis.

**Reynolds:** R&W insurance will become the norm for M&A transactions. As sellers use the product to limit or eliminate the amount of capital they tie up in escrow, buyers use the product to position their bids, and both parties use insurance to eliminate contingent liabilities, uninsured

deals will increasingly become exceptions. The use of tax insurance is expected to grow rapidly as awareness and acceptance of the product develops. This process will be expedited because the same brokerage firms, managing general underwriters (MGUs) and insurers who write R&W insurance are familiar with and increasingly sophisticated about tax insurance.

**Hernández:** W&I insurance has become a common feature of M&A transactions in recent years amid a strong sellers' market that has enabled vendors to offload risk to buyers. US buyers are very active in Europe and Asia-Pacific (APAC) deal markets and their influence is becoming increasingly evident in W&I terms. US buyers are pushing for more US-like W&I terms on non-US deals and the changes have enhanced policies. Additionally, I also see some emerging trends in 2019, such as synthetic tax deeds, knowledge scrapes and growing use of W&I insurance on auction processes and for SME deals.

**DeLott:** The transactional risk management process will continue to evolve to meet the needs of businesses around the world. It will also become ever more professional as shareholders recognise the risks of poor transaction execution, particularly in large, transformational deals. Transactional risk management will receive more attention in business school classes, by using notable failed transactions as case studies. And the insurance industry and financial markets will likely continue to create new products to address transactional risk, including political risk, risks relating to a warming planet and risks that have yet to emerge. ■

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