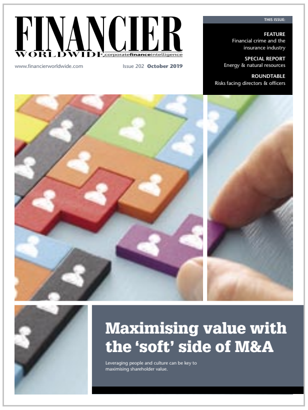
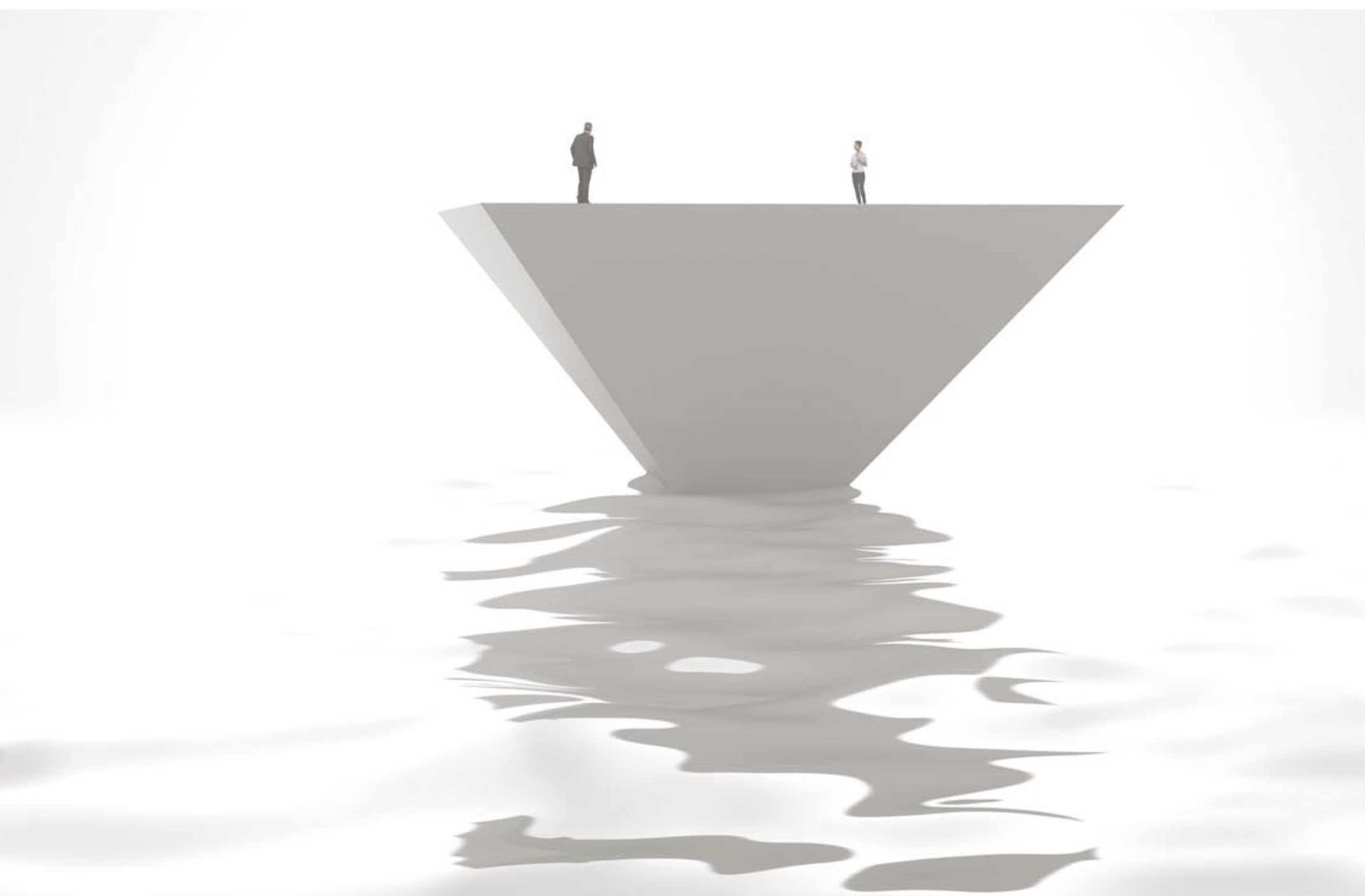


Published by Financier Worldwide Ltd

TALKINGPOINT October 2019

Transactional risk insurance

FW moderates a discussion between Jeffrey Anderson, Wayne Datz, Andrew Belisle and Ryan Anderson at ASQ Underwriting on transactional risk insurance.



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Jeffrey Anderson is currently director at ASQ Underwriting, a boutique transactional risk managing general underwriter (MGU). He co-founded the new underwriting facility in 2018, following 24 years of diverse insurance experience, including leadership positions with a global insurance brokerage firm and two global insurance carriers. In his most recent role, he served as North American M&A practice leader for a global specialty insurance carrier, a practice he launched in 2011. He holds a Bachelor of Arts degree from the University of St Thomas and a Juris Doctor degree from William Mitchell College of Law. He is frequently called upon to speak at M&A insurance events, conferences & other functions and has written white papers for various publications.

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FW: What factors are driving the rising awareness of, and appetite for, specialist insurance to mitigate M&A-related risks?

J. Anderson: As representations & warranties insurance (RWI) becomes more prevalent, potential buyers and their advisers are learning how to efficiently integrate RWI and the underwriting process into their broader deal process. Buyers, particularly repeat buyers, are increasingly comfortable with the underwriting process and the coverage being offered, so there is less concern that major, unexpected exclusions or delays will arise in underwriting, potentially jeopardising a deal. Buyers and their advisers understand underwriters in the RWI space, many of whom are former M&A lawyers, and are willing and able to quickly mobilise and perform underwriting on timelines that allow buyers to complete transactions on time. In short, execution risk is generally not an issue with established underwriters.

Datz: Buyers and their advisers are increasingly seeing claims paid under the prior year's RWI polices, which is giving parties greater comfort that RWI will be available as a source of recourse to replace an escrow.

R. Anderson: With its increased prevalence, we are now seeing parties build RWI into their expectations when beginning a transaction – often with letters of intent (LOI) and term sheets contemplating the use of this product. So the product is used proactively, rather than reactively as it had been for years past.

FW: Is it relatively uncommon to see M&A deals reach completion without some form of insurance component? How has this trend changed over the last 5-10 years?

Belisle: While M&A insurance usage has seen rapidly increasing use over the last 5 to 10 years, we know statistically many deals are proceeding without insurance. According to industry reports, M&A insurance is used in under 40 percent of all middle market North American transactions, so there is room for continued growth in the industry and more widespread adoption of the product, particularly among strategic acquirers, in certain niche industries and for smaller enterprise value transactions.

R. Anderson: In the last few years, as the product has been more widely adopted as a deal tool, particularly among private equity (PE) buyers, we have seen more deals getting done on shorter time frames, such as very limited exclusivity windows. This has increased competition among buyers to provide sellers with aggressive time frames for deal completion, and therefore more deal certainty. That competition is increasingly driving strategic acquirers to explore the use of the product to remain competitive with PE buyers.

FW: Drilling down, could you elaborate on the benefits that representations and warranties insurance brings to the M&A context?

J. Anderson: RWI provides a range of benefits to buyers and sellers in M&A transactions. One of the most attractive benefits is the ability for parties to reduce the amount of the sellers' escrow. Under a traditional indemnity structure, 10 to 20 percent of the purchase price would be put into an escrow account that could be accessed by the buyer in the event of a breach, to be released 12 to 18 months after the closing. Using RWI, the amount put into escrow is typically 2 percent or less, giving the sellers access to additional cash at closing. Buyers are able to use that benefit to make their bids more attractive, giving them a competitive advantage over other bidders who are not offering to use RWI.

R. Anderson: For buyers, RWI in many ways provides more protection than under a traditional indemnity. In a traditional indemnity structure, in most cases when the escrow is released 12 to 18 months after closing, the buyer no longer has any recourse for breaches of the representations and warranties, other than fundamental representations. Using RWI, the buyer will have recourse for three years, and in some cases longer, for breaches of operational representations, enhancing its protection.

Belisle: With RWI, buyers are able to better protect their relationships with management and other sellers in the event of a claim. Under a traditional indemnity structure, claims would need to be presented to, and argued with, the sellers in the original transaction, which can put stress on relationships, particularly when the sellers include members of management who are continuing to work with the business. Using RWI, if a claim arises, it can be handled directly with an insurance company, which avoids uncomfortable discussions with management and the potential for distracting them from running their business as they deal with claims.

Datz: If a breach claim arises, the insured is dealing with a professional claims paying insurance company, rather than trying to prove damages and access an escrow. We view this as a significant improvement versus dealing with a seller that is handling a breach for the very first, and perhaps last, time. Insurance companies have claims-paying reputations that help inform their decision making.

FW: Are you seeing rising demand for tax liability insurance? What does this entail?

J. Anderson: Like RWI, tax insurance adoption has increased significantly in recent years. This includes coverage for tax opinion risk and also tax credit recapture risk. For North America, there are about half as many tax insurers as RWI insurers, but the tax underwriting capacity grows

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> ASQ Underwriting

GIVEN THE UNIQUE NATURE OF THE RISKS COVERED BY CRI, THE POLICY DRAFTING AND NEGOTIATION PROCESS WILL TYPICALLY TAKE MORE TIME THAN FOR RWI.

WAYNE DATZ
ASQ Underwriting

FOR NORTH AMERICA, THERE ARE ABOUT HALF AS MANY TAX INSURERS AS RWI INSURERS, BUT THE TAX UNDERWRITING CAPACITY GROWS EACH YEAR.

JEFFREY ANDERSON
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each year. Tax opinion insurance solves for a known tax issue, where the outcome and damages are in question. Of course, this is the opposite of RWI which insures for unforeseen breaches of the seller representations. So, tax opinion coverage insures a discreet, and often complex, issue and allows deal parties to proceed toward closing the transaction. Like RWI, one of the significant benefits is for sellers to avoid an escrow, allowing them to access more cash at closing. Tax credit recapture insurance is often used to entice investment in projects that receive tax incentives. By de-risking a project, developers are able to attract more capital, and sometimes a different group of investors who are less risk tolerant. This coverage can cover a variety of risks, depending on the specific tax credit insured and parties involved in the deal. We expect the North American tax market to continue to increase over coming years.

FW: Could you outline the function of contingent risk insurance and how it ties in with the due diligence process?

Datz: Contingent risk insurance (CRI) provides coverage for a known transactional liability. When deal parties cannot agree on the outcome or quantum of a specific issue, a large indemnity from the seller may be required or the issue may stall the deal. In those cases, CRI can provide coverage for the contested issue, allowing the parties to move toward deal completion. This is very similar to tax insurance. Every CRI process is different given the range of issues that could arise in an M&A context, but the process is fairly similar to an RWI underwriting process. In general, underwriters will expect that complete due diligence has been performed on the issue, using highly-qualified advisers. Underwriters will want to see thorough reports prepared by such advisers and would typically want to have an in-depth underwriting call to discuss questions they have after having had time to review reports. Given the unique nature of the risks covered by CRI, the policy drafting and negotiation process will typically take more time than for RWI.

FW: How have insurance providers evolved their M&A-related policies in recent years to meet market needs? What notable changes have you seen to the coverage and pricing on offer?

Belisle: As adoption of the product has increased, there has been increased competition among insurance providers, so we have seen coverage terms expanding, with retentions also coming down on larger transactions. We have also seen coverage terms broaden with RWI being offered on transactions that were harder to insure in years past, particularly with heavily regulated industries, such as healthcare and financial services. We view this as a very normal insurance cycle, where capital comes in to solve for more transactions.

J. Anderson: RWI insurers have also become more flexible with the form of diligence they are willing to accept. Particularly for strategic acquirers, which often conduct diligence in-house, underwriters have become more willing to consider internal due diligence reports rather than insisting on the typical full suite of third-party reports, which is common for PE buyers.

R. Anderson: Insurers and underwriters are increasingly offering RWI on low and high enterprise value deals. Insurers are providing limits under $5m and on transactions with enterprise values down to $10m, and in some cases lower. With the large number of insurers offering RWI now, total capacity has increased and has allowed for large placements on high enterprise value deals – more than $5bn transaction value – where coverage was previously not feasible given capacity limitations.

FW: Based on your experience, what considerations do parties need to make when assessing their options for M&A insurance?

Belisle: The two primary factors parties should consider when selecting an insurer are the underwriter's experience and claim-paying ability. It is important for underwriters to quickly and predictably complete the underwriting process so no deal is put in jeopardy due to RWI. Just as important is the carrier's reputation and ability to efficiently pay claims under an RWI policy, so parties have real recourse in the event of a claim.

R. Anderson: Parties should seek to work with RWI underwriters with experience in the space who understand the demands of parties to M&A transactions, and have a track record of meeting parties' time frames and coverage expectations. Underwriters who are able to creatively and predictably respond to underwriting challenges will help deals stay on track and allow parties to obtain RWI coverage that is consistent with their expectations.

Datz: RWI policies are only as good as the ability of the insurer to pay legitimate claims in an efficient manner. Therefore, parties should seek out insurers that have the ability to, and reputation for, paying claims and managing the claims process efficiently. Parties should make sure to understand insurers' reputations for claims handling and should understand how much involvement underwriters will have in the claims management process. Having underwriters involved in the claims process is critically important to ensure that the process is handled consistent with the parties' expectations, as there can, at times, be disconnects between the expectations of parties in the M&A space and in the general insurance space.

FW: In your opinion, what is the future of M&A insurance? What predictions can you offer about products and their usage in the months and years ahead?

J. Anderson: We expect to continue to see the widespread use of the product, with increased use on smaller and larger deals. We expect that RWI will gain more widespread acceptance by strategic acquirers and will be used on the majority of deals in the coming years. This is regardless of an economic contraction, since there is significant under penetration right now, and deal parties have now accepted this insurance as a useful and normal tool when transacting. ■