"Transaction Insurance as a M&A Strategic Tool"

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The use of insurance in M&A transactions is gaining popularity among deal professionals who are finding this tool increasingly useful to bridge the gap on one of the most fundamental deal issues in any M&A transaction: the potential post-closing erosion of value (either of the consideration received by the seller or the business acquired by the buyer). Some of the most popular types of transactional insurance policies available to buyers and sellers are representations and warranties ("R&W") insurance, tax indemnity insurance, and contingent liability insurance, with R&W insurance being the most common. Join:

- **Markus Bolsinger**, Partner, Dechert LLP
- **Jim Epstein**, Partner, Pepper Hamilton LLP
- **Matt Heinz**, Managing Director, Aon Transaction Solutions
- **Scarlet McNellie**, Partner, Norton Rose Fulbright US LLP
- **George Wang**, Counsel, Haynes and Boone LLP

Broc Romanek, *Editor, DealLawyers.com***:** Welcome to today's program, "Transaction Insurance as a M&A Strategic Tool." Let me go ahead and introduce the panel. We last did this program in 2012, shortly after transaction insurance started taking off in the U.S. as an M&A tool. Of course, it's continued to grow here. Markus Bolsinger is a Partner with Dechert. Jim Epstein is a Partner with Pepper Hamilton. Matt Heinz is the Managing Director of Aon Transaction Solutions. Scarlet McNellie is a Partner of Norton Rose Fulbright. And George Wang is Counsel with Haynes and Boone.

Let me turn it over to Markus to kick us. He will set the table with a discussion of the lay of the land and an overview.

Transactional Risk Insurance Overview

Markus Bolsinger, *Partner, Dechert LLP***:** Thank you, Broc. Thank you Deal Lawyers for hosting us. And thanks to all of you in the audience.

I thought we'd start by talking about when M&A insurance is used and what the typical terms and conditions are, which will set the table for the discussions that will follow thereafter.

If you step back and think about what rep and warranty insurance is, it's really a way of handing a problem off to someone else that neither the buyer nor the seller wants to deal with when there is a transaction. In all deals, as people in the audience know, the buyer always wants to get coverage for every potential risk that's out there when acquiring a company. And the sellers generally just want to take their money off the table and go home. Those negotiations can be pretty drawn out and are not always very friendly.

Rep and warranty insurance, while it has been around for 15-20 years, really took off in the last three or four years. Dechert put out a presentation over the summer which said that rep and warranty insurance was no longer optional. We felt that, over the course of the last three or four years, rep and warranty insurance in the middle market has taken off so much that if you are in a competitive process, you almost have to use it in order to be competitive at the table when a seller is deciding who to team up with.

That being said, what does rep and warranty insurance do? It covers and backs up in a transaction the reps and warranties made by the sellers, generally, to the buyer. There are two different ways it can work. Either it gives "direct recourse" to the buyer, after some terms that we'll go through in a second, to the extent the seller's reps were breached or inaccurate. There is also a less-used version, where the seller contractually indemnifies the buyer, but then the seller offloads some of that risk in something called a sell-side rep and warranty policy.

How does a rep and warranty insurance policy work? It bridges the gap between the seller and the buyer on what gets indemnified, the length of time the seller will be on the hook, and the cap - or the limit, in insurance terms - that can be recovered. One reason that rep and warranty insurance has become more and more popular is that it is actually helpful, in the sense that a seller does not want to be on the hook for 12 to 24 months. I think that's where most of the middle market deals that still have indemnifications are.

Under the typical policy, you can get three years for general reps, and for the more fundamental reps, up to six years. A tax indemnity - "We paid all of our taxes," "There haven't been any audits," those kind of things - will also be picked up even if it's drafted as a covenant. The underwriters agree to that and cover it even though it's not technically a rep or warranty.

What reps does a typical policy cover? Does it cover all of the reps in the purchase agreement? The typical lawyer answer is, "It depends," but generally, the answer is yes.

There are deals that are done overseas where maybe the Foreign Corrupt Practices Act may be an issue. People will look very carefully how that rep is drafted and what will be covered.

If you go into countries where accounting may not be as solid as it is under U.S. GAAP, you may have issues with the financial reps. If you include a Rule 10b-5 rep, which is not that typical, at least in the U.S., those may be excluded. But generally, environmental, employee benefits and

taxes are covered, as I said, both as a rep and as a covenant. So generally all the reps and warranties in the Stock Purchase Agreement are covered.

The underwriters are smart. If you were to just "wink, wink" to the seller and have a rep and warranty package that's so far off from what people expect it to be if there were no insurance, you'll probably get slapped on the hand, and you will not get the deal underwritten.

Jim Epstein; *Partner, Pepper Hamilton LLP:* Markus, just to dig a little deeper - at least in our experience, there are a couple of areas, in tax for example, that would not get covered - things like NOLs and other kinds of tax attributes. The carriers seem to be shying away from that. In the pension area - for example, reps regarding whether a particular defined benefit plan is funded properly - they seem to be shying away as well, because of the valuation issues.

And Matt Heinz, I'm sure, can talk about the whole healthcare reimbursement and fraud and abuse area. That, as well, is something that is very difficult to get insurance for.

Bolsinger: I have to agree that while the reps are generally covered, there are exclusions, as you said. There are certain areas where you may either not get full coverage or have additional things that need to be negotiated in the exclusions.

Matt Heinz, *Managing Director, Aon Transaction Solutions:* I think that that's all very correct. I generally tell clients to think of rep and warranty insurance as covering the unknown. And as you drift toward a more known issue, whether it's tax or any other heightened concern, that can generally be handled on some other type of product. It's not going to be within the domain of the rep and warranty product.
With respect to healthcare, there's been sort of a black hole for us for a quite a long time around reimbursement or billing risk within the healthcare regulatory scheme. At Aon, we tried to develop a separate product that addresses that, where we carve out healthcare and billing risk and place it on a separate product with a different carrier, underwritten by a separate consultant. That's because ultimately, within the traditional rep and warranty realm, billing risk, CMS risk and any type of healthcare regulatory risk is generally either out of bounds or only covered at a very high retention and for a very high price.

So that's one of the areas where the product is evolving. I don't want to get too deep into it on this webcast. But in all areas like that, whether it's pension issues or tax issues or healthcare issues, you should think about rep and warranty insurance as covering the basic reps in any given deal around the unknown risks of a target business. And to the extent that you get something that's much more hazardous or rises to the level of a known issue, then you're going to have to talk to your broker and look to some sort of other product to potentially cover that.

Bolsinger: Right.

As I said a few times, this insurance is mostly used in the middle market. The reason is that there is a minimum of what people want to underwrite. It's generally around $10 million of limit that you buy. It probably doesn't make sense to buy that for a $10 million deal.

And the maximum that the market can underwrite is somewhere between $300 and $400 million. The largest amount, which we did with Matt at Aon, was just shy of $320 million, a year-and-a-half ago.

New capacity has come on to the market, but that's probably what limits you on how much coverage you can get. Then, depending on the risk appetite of your buyers if it's a buy-side policy - Scarlet will be talking about the difference between buy-side and sell-side - if you want to have roughly a 10% coverage for breaches, that gets you somewhere to a $3 billion to $4 billion dollar deal.

I think the sweet spot, probably, on the deal side, is between $100 million and $500 million. You can go up, and we all have done that. But that's the sweet spot where it's used.

Currently, I think we have all seen new areas where rep and warranty insurance may be used. One is smaller companies going private, where there's absolutely no indemnity from the sellers. People have tried using it in 363s, like bankruptcy sales. But deals between $100 million and $500 million are really the sweet spot.

Who is buying this insurance? A lot of what we see are financial buyers - private equity portfolio companies that have to comply with some financial covenants under their credit agreements - where a loss may be more significant than for a large strategic buying a similar-sized company.

Heinz: I'd love to chime in on that quickly. Part of the reason I'm here from the brokerage side is to give the state of the market. From a capacity perspective, that's certainly an area that's been rapidly evolving.

A year ago, at this time, we probably had six primary carriers that you could approach on any given deal. I call them the Original Six, to use a hockey term. We're probably up to something more like 11 or 12 potential primary targets on any given deal these days. There are obviously going to be differences amongst all of those, with respect to execution ability, sweet spot on risk appetite, pricing and retention levels, and so forth. But there's a lot more capacity out there.

With respect to the $300-400 million deal size, it's probably ticked a little bit upward now. We're pretty confident that we can place somewhere between $500 and 600 million these days.

The market is extending upward into $4 billion to $5 billion or even $5 billion to $6 billion deals.

The market is also extending downward. It's always been a challenge for us to place very small limits on much smaller deals. That's because carriers are a little bit more reticent to work on a deal with advisers that they might not know on a regional basis or where they can't get some minimum level of premium.

That's been another development over the last six months to a year - we've seen some carriers focus a lot more energy and time on covering and placing limits below $10 million. They are basically saying, "We're not going to negotiate the policy quite as robustly or as intricately. We're going to set out a policy that's kind of take it or leave it, or closer to take it or leave it, than we have on the bigger deals. A minimum premium is going to be asked. But now we can address some of those deals."

Historically, the sweet spot has been from $100 million to the $500 million or $750 million range. But we're actually growing toward both ends of that, expanding out the spectrum a bit, which is pretty interesting. And the growth has been tremendous.

Epstein: On the high side of that sweet spot, isn't another challenge that you really are dealing with multiple carriers at that point in time?

Heinz: Yes. Absolutely.

Epstein: You have to layer your coverage, in a sense. The first $40 or $50 million of insurance costs more than the next $40 or $50 million and so on, given the layering approach.

Heinz: That's right. All of those larger insurance programs will be stacked, almost like a layer cake. You will have a primary carrier, who will provide somewhere between $30 million and $40 million of coverage. And we build out excess layers above that in additional tranches of say $30 million or $40 million, and then eventually, in larger slugs of insurance, on a quota share basis, which means that multiple carriers contribute to the same layer of insurance in layers of say $100 million or so. And your pricing does go down on each successive layer.

The challenge on the bigger deals, Jim, is then finding carriers who are willing to sit as the primary. That's because part of the way that carriers price out their coverage in this space - we could talk about pricing in a minute as well so folks understand the economics - is based on what layer of deal consideration they are covering.

If you are talking about a $5 billion deal and a $30 million primary layer of coverage, excess of a 1% deductible or threshold, if you will, before the coverage kicks in, they're covering dollars that are actually pretty close to what would traditionally be a retention. So the pricing on that is going to be a lot higher. They're covering a much smaller piece of a much larger deal and that gives them a little bit more hesitation.

So finding that primary carrier is the challenge on those bigger deals. But once we have a primary option, it's usually off to the races, because after that the excess coverage is pretty readily available.

Difference Between Buy-Side and Sell-Side Policies

Romanek: Why don't we go ahead and turn it over to Scarlet now to talk about the differences between the buy-side and the sell-side policies?

Scarlet McNellie, *Partner, Norton Rose Fulbright US LLP***:** OK. Thank you, Broc, and thank you, Markus for leading us off. I wanted to talk a little bit about the difference between a buy-side policy and a sell-side policy.

There are two types of representations and warranties insurance policy. There's a buy-side policy and sell-side policy. The key differences, obviously, are who the insured party is and who's covered.

For a sell-side policy, the insured party is the seller in the transaction. This type of policy really operates as more of a backstop policy. The insurance company is providing coverage in the event that the buyer goes after the seller for breaches of reps and warranties in excess of the retention or deductible under the purchase agreement. The insurance company will either reimburse the seller for losses incurred, or will pay the purchaser directly on behalf of the seller for those losses incurred as a result of the breaches of reps and warranties.

Note that generally only 10% to 15% of these rep and warranty policies are sell-side policies. The more common policy that is underwritten is the buy-side policy.

Here, the insured party is the buyer. The objective is to provide coverage against financial loss suffered as a result of the breaches of the seller's reps and warranties. Typically, the sellers give warranties and indemnification, but this is capped at a much lower amount, and the insurance company sits in excess of this.

Under a buy-side policy, the buyer, instead of going after the seller for a large indemnification, essentially limits the amount for which it will go after the seller, and it will now go up to the insurance company for the indemnification obligation. Here, the seller reduces its indemnity and the risk of post-closing obligations; it can also reduce its escrow holdback. For the buy-side, it provides extended coverage, and often it will provide broader coverage for reps and warranties than under a typical deal.

Again, buy-side policies are much more common. Usually, about 85% to 90% of the policies are buy-side rather than sell-side.

I wanted to touch a little bit on some advantages for sellers in obtaining reps and warranties insurance. Then I'll talk a little bit about key advantages for buyers.

On the sell-side, obtaining reps and warranties insurance typically will reduce the risk of contingent liabilities arising from future rep and warranty claims. Also, it will typically expedite the sale and potentially increase the purchase price, because it will eliminate obstacles to closing such as indemnification negotiation. In an M&A transaction, typically the things that people negotiate are the basket, the cap, and the survival of reps and warranties. Now you've got sort of a package that can streamline that process.

Sell-side insurance can allow a seller to distribute all or most of the sale proceeds to investors. It can also protect passive sellers who have not controlled or been actively involved in the management of the target company. Those are the sell-side advantages.

On the buy-side, advantages for buyers who obtain that type of insurance include enhanced protection for breaches in reps and warranties, supplementing what's provided under the purchase agreement, such as extending the survival. Typically, under an M&A deal, you're looking at 12 to 18 months. But a buyer may want more coverage. Under most policies, it's up to three years, and then the statute of limitations or six years for what I'll call the "fundamental" reps and warranties.

As people talked about earlier in the program, for a buyer in a private equity context or in a competitive auction process, a key way to distinguish your bid is by accepting lower indemnification from the seller and then supplementing that with a policy that you have in your back pocket when you submit your bid. Your bid is obviously going to look a lot more appealing to a seller if there's a much smaller escrow or even no escrow at all, and you've got an insurance policy ready to cover you for the upside.

Also, to the extent you've got any concerns about the seller and being able to collect on the indemnification claims, either because the seller is in serious financial condition or is a private equity investor that is has to distribute all of its funds, you can now go after an insurance company, which obviously has a lot more dollars to back those indemnification claims.

Finally, to the extent that you've got sellers who end up as key employees post-closing, you don't want to have to go after them. So now, you've got a policy that can cover you for potential breaches of reps and warranties.

That's sort of a sum up of what the differences are between a buy-side policy and a sell-side policy and the reasons why buyers or sellers would want this type of insurance. Now, I'm going to turn it over to George, who's going to talk about some types of reps and warranties insurance claims.

Types of Reps and Warranties Insurance Claims

George Wang, *Counsel, Haynes and Boone, LLP:* Thank you, Scarlet. The next topic, which I've been asked to discuss, are the types of claims that we incur in rep and warranty insurance. I will go into some of the statistical information as to the type of claims that the carriers are seeing. But before doing so, it may be helpful to go into a little more depth about the nature of the product and how that impacts the type of claims that we can see.

As a general overview, the rep and warranty policy is very different from a casualty insurance product, in the sense that R&W policies can be negotiated with the carrier. They can be modified as the buyer and the seller deem necessary to bridge gaps that the parties may have in their ultimate deal valuation and "bid ask" in completing a deal.

The basic rep and warranty policy - and I think Markus indicated this - is intended to cover unknown and unforeseen claims. We all know how that works in M&A transactions.

One thing you need to keep in mind is in the area of taxes. As a practitioner, you may draft an M&A agreement to provide specific reps and warranties as to specific tax matters, such as a representation that, "There are no tax claims."

Or you might take a different approach, where you may not have a very fulsome set of reps and warranties, but rather rely on a blanket tax indemnity in your agreement. If you're a buyer in that context, and you are simply relying on the tax indemnity to cover tax liabilities, you want to be sure that your policy covers the tax indemnity, as there may not be any breach of a tax representation.

Another area, as Scarlet already described, is the significant distinction between the buy-side and the sell-side policies. On the sell-side, the R&W policies function similarly to typical insurance policies - the seller will be protected against defense costs it incurs in defending an indemnity claim that the buyer may assert against the seller and for damages incurred by the seller. In contrast, in a buy-side policy, the buyer typically will have direct recourse against the insurer for the breach of a representation subject to the negotiated terms of the policy.

Sometimes, we see situations where the buyer may try to prioritize rights against an insurer, vis-à-vis the seller. That can be an effective tool for bridging issues between the buyer and the seller. Again, these policies are very flexible.

Another area to think about are the anti-sandbagging provisions. If you're a buyer, you typically want to provide that buyer's knowledge in a deal should not affect its right to assert a claim against a seller. The insurance policies have not fully adopted this position and tend to include a knowledge qualifier of the insured (the buyer in the typical buy-side policy), effectively creating a sandbagging concern.

The good news is that the definition of knowledge can be very narrowly drafted to essentially consist of the buyer's deal team. It's not a "should have known" or "could have known" type of standard. But again, in looking at these policies, you want to be cognizant of those issues.

Finally, I think it was mentioned earlier that these policies now tend to cover most if not all of the representations and warranties. There are still potential exceptions that you need to carefully consider. For example, if you are acquiring a company that's heavily involved in environmental concerns, such as power plants or a landfill, the insurance companies may seek a carve-out of environmental claims, and ask that the buyer obtain a separate environmental policy to cover those risks.

In terms of the nature of claims asserted, there have been some recent surveys indicating that the largest number of claims fall in the following categories - claims related to: (1) financial statement, accounts receivable and inventory; (2) compliance with law; (3) tax; (4) undisclosed liabilities and (5) IP matters.

Romanek: Thanks, George. Matt, do you want to talk about the state of the insurance market? I know you already started talking about that topic a little bit.

State of the Insurance Market

Heinz: There are two things that I think are important to mention on the market.

First is pricing. Historically, this product was uber-expensive and not really very attractive when it first started up, back in the 2001 - 2002 timeframe.

For a long time, the pricing was in the 4 to 6% rate online range. In insurance terms, that means the pricing would be 4 to 6% of the limit of liability that was purchased. From 2008 to late 2009, when the M&A market fell off a cliff, the underwriters that were running this business were basically like rabid dogs fighting for a few scraps of meat. There were so few deals out there.

So that historic rate in the 4 to 6% range was forced to drop due to competitive reasons. The underwriters dropped the rate down to somewhere closer to the 2 to 3% rate online range.

We've talked very much today about how buyers and sellers use these products strategically. It was when that price dropped, and as the product became more economically acceptable, that people started broadening out terms and using the product more frequently.

The light bulbs sort of went off - this isn't terribly expensive anymore. It's reasonably priced. You can actually use it. You can broaden the terms now and get better coverage than you had in the past around anti-sandbagging and things like that. So as demand then grew, based on the lower pricing, coverage started growing. And demand increased even further.

With that increased demand and broader coverage of terms, pricing has now ticked back up, for good coverage in the U.S., to 3 to 4%. But I think that in reality - and Markus, Jim, George, feel free to chime in - probably 3.5 to 4% is what we see on most deals these days for top of the market coverage, with minimal exclusions around loss, with full materiality scrapes, and the best coverage that we can get.

That 3.5 to 4% rate online range is also tied to a retention level. Every one of our policies has a retention, effectively a deductible, of somewhere between 1 and 2% of enterprise value. Within that 1 to 2 %, there's usually some level of buyer deductible, and then some level of seller indemnification on top of that. The combination of those two will get you to somewhere within 1 and 2% of enterprise value.

Or we can do a flat "no seller indemnity" deal, where there's no seller indemnity whatsoever, and the full brunt of the retention is borne by the buyer. In those cases, we usually see retentions of somewhere between 1.5 and 2% of enterprise value. Again, that's fully borne by the buyer, in the form of a true deductible.

So assume generally, in the market, 1.5 to 2 % as a retention. For coverage above that, if you're insuring roughly 10% of deal size (a historically average indemnity cap), assume a rate in the neighborhood of 3.5 to 4 % rate online.

Wang: And Matt, in the "no seller indemnity" scenario, are the premiums about the same, this 3.5 to 4 % range? Or are they higher?

Heinz: You know, George, the premiums may pick up a little bit. We more often see the flex or the wiggle on those deals when there's no seller indemnity in the retention as opposed to the pricing. There's usually some impact on pricing, but it's not material, it's not 50% or twice the price, something like that. It's typically basis points. It's not a drastic increase in price. But you will see a difference in retention.

Whereas, if there's some seller indemnification involved, we can sometimes push down to a flat 1% with a 50 basis points split. So you have a 50 dip to your deductible and then a 50 dip to your seller indemnity.

I know in some indemnity deals, it's very challenging to get to 1%. We're more often starting at 1.5% or even 2% as a retention.

For all the M&A lawyers in the audience, keep in mind that, at least in this market, true deductibles are usually 50 dips to 75 dips, or even 1 %. The challenge, on n those deals when there's no seller indemnity, is that all of a sudden, you're asking a buyer to bear 1.5% or 2 % of the deal value in risk, before they can bring a claim and before they can recover dollar one on a breach. That's a hefty pill to swallow for a lot of buyers and makes it a little bit less palatable.

Epstein: Yes, it does. But that gets into, of course, the negotiation between buyer and seller. Maybe this product gives you three years versus 18 months coverage time on the reps. This product might give you a materiality scrape. This product might give you a whole host of other features that you might not otherwise get. These are all going to be trade-offs. We'll talk about this again when we talk about some of these negotiations in a minute.

Heinz: Yes, I agree with that.

Wang: In the context of an equity rollover transaction, it could be very desirable not to have a claim against a seller.

Heinz: That's definitely right.

And Jim, to your point, if I were to make a broad-brush characterization, I think that, even though there's such a strong seller's market in the M&A landscape right now, on deals where there is some rep and warranty insurance as part of the indemnity solution and the risk allocation, you tend to see more buyer-friendly contracts than you'd expect in a very seller-friendly environment.

That's because buyers respond to sellers by saying, "I'll accept your request for a minimal indemnity here, 50 basis points or 1% or whatever the number is. But that's a very thin sliver of risk that you're assuming. And as a *quid pro quo* for that and for my concession on the indemnity cap, I need you to give on things like materiality scrapes or on silence on consequential laws, multiplied damages, diminution value, things like that."

So if you want to see a better indemnity structure that's more buyer-favorable, it's almost as a *quid pro quo* for the lesser indemnity cap that the seller has to absorb.

Epstein: Yes. And, as was pointed out by Markus in the beginning, within the bounds of reasonableness, you tend to see a more buyer-friendly set of reps and warranties as well.

Heinz: Yes.

Epstein: So, for example, even in private companies, you may see a much more expansive financial statement rep, with specific reps about inventory and receivables depending upon your business and things of that nature, which you might not otherwise see in a deal without rep and warranty insurance.

Heinz: Yes. And just to carry the torch for the underwriters for a quick moment, that's not an invitation to craft an egregiously buyer-friendly purchase agreement, thinking that you can slip whatever you want past the underwriters.

These folks are very smart. They're all former M&A lawyers as well. And they will be able to spot a really off-market or abnormally buyer-friendly rep. They will normally push back on that or try to carve it out or something. They're willing to cover a buyer-friendly contract, but still it's got to be within the bounds of reason and rational negotiation.

Epstein: Within the realm of reasonableness.

Bolsinger: And I think that, for all of us who have been doing this for a while, you realize that there's a lot based on relationships - either the relationships with the brokers, or the relationship between the underwriter and the private equity shop as a repeat customer. It's all long-term relationships. No one is really trying to get a great deal once and then never use it again.

If you go into negotiating a rep and warranty policy with more of a partnership approach, still looking out for your client, but having something that needs to be sustainable in the long run, I think that's the right approach, rather than to take a one-sided approach on one-off deals.

As Matt said, the underwriters are very smart. If you try to get something by them that's so buyer-friendly that no one in their right mind would indemnify for the risk, that may spook them enough that, even after the purchase agreement gets pared back, they may not want to underwrite it at all. I think that's another consideration that people need to take into account when trying to get a very single-sided purchase agreement past the underwriter.

The Insurance Underwriting Process

Romanek: Matt, do you want to give us an overview of the underwriting process itself? Anyone else can chip in with their perspective from the other side.

Heinz: Yes, absolutely. In general, you should assume that our process takes about two weeks from soup to nuts, from the time that we on the broker side do the initial call with the client and with deal counsel.

Normally, in that initial call, you'll discuss what you are looking to accomplish with the insurance. Are you trying for the lowest retention possible? Are you trying to eliminate any indemnification? If you're a seller, are you happy to accept some level of indemnification in order to reduce pricing and make the process easier? If you're a buyer, do you need to go the "no seller indemnity" route in order to win the deal? We'll go through all of that.

Once we get a sense of what you're looking for, in terms of the size of the deal and the limits desired, there are three things that we need on the broker side in order to get a quote. First, we need the latest draft of the purchase agreement, preferably a buyer draft if there's one available, since that will reflect the height of severity of rep language and indemnity structure. Second, we need a SIM or a management presentation, something that describes the business in a little bit more depth. And last, we need the audited financials.

Once we have those three documents, and we have a sense of the insurance request and the parameters, we'll go out to the market. We normally get quotes back within three to four days. Then we will have a proposal back to the client and counsel, outlining the market response. Who responded and who declined the deal? What do our retention levels look like? What is the pricing like? What are the potential exclusions, based on the information provided thus far and the sector that we're covering?

Once the client selects the carrier as the horse that it's going to run with and use to underwrite the deal, it's usually another five to seven business days for the deal to be fully underwritten and the policy negotiated.

I'm talking about a buy-side process here since, as Scarlet mentioned, probably 80 - 90% of our deal these days are buy-side.

The carrier will get access to the data room on the deal. And they'll get access to all the legal, financial and other advisors' diligence reports on the deal. That means they will get any third party diligence report commissioned and received from a lawyer, a financial advisor, an environmental expert, an IT expert, and so forth. The carriers will take a few days to go through all of those materials.

Bolsinger: Everything that Matt said is absolutely dead on. One thing you need to address early, if you represent a strategic buyer who's doing some or all of the diligence in-house, is to explore with that client to what extent they are willing to share their internal documents with the underwriter.

It has been our experience that if you address this issue upfront - "This is how much we disclose. This is going to our board but it's not something we want to have out there" - the carriers will generally respect your decision. But they will take it into account in the pricing and in deciding whether or not that they are going to write the coverage.

Heinz: Markus, that's a great point. That's absolutely right - we normally ask that before we go out with the submission. We alert carriers to that, because it will have some impact. If there are no diligence reports wrapped up in a bow from the law firms and financial advisors and so forth, it's going to take the carrier a little bit more time to underwrite that deal. And it will impact their quote - the underwriting fee that they request.

So that's absolutely right. That's one of the items that we cover on the front end before we go out to market.

Just to jump back in, when we do hit the button with the carrier, there's usually a five to seven business day period after they get access to all these diligence reports. With a corporate, they won't have access to reports, they'll just get access to the data room. We'll do a diligence call with the underwriter and with the deal team for the buyer, for the named insured. It's usually the two, three or four folks who are most relevant to the diligence process, sort of the decision-makers within the deal, as well as counsel and any other advisors - financial and tax advisers definitely - who have assisted with diligencing the deal.

On the day of that call, we normally get a draft policy from the carrier later in the day, as well as any follow-up questions. And there's typically another day or two of negotiation and answering follow-ups before that policy is done and ready to be bound.

So, all told, when you take into account the first three to four days to quote the deal, and then the five to seven business days to underwrite and negotiate the policy, it's usually about two weeks. That being said, we certainly have operated on a faster timeline when necessary. I think everybody on the panel has probably been on a call with a broker or an underwriter on a weekend or late at night before a signing or closing.

The folks in our space are all former M&A lawyers and work on deal time, so to speak. But on average, I would safely assume a two-week window in order to get your deal done.

Wang: By the way, Matt, while we're talking mostly about buy-side policies, a seller can initiate that process as well.

Heinz: That's right. We call that the "seller flip" process, where we go out on behalf of a seller and price out the market for them in advance of soliciting bids. That way, when they post their initial Stock Purchase Agreement to the data room, they'll post alongside that SPA a letter, usually from the broker - hopefully Aon - indicating what the insurance response on this deal would be. For example, it might say, "Insurance on this target would cost up to 10% of the deal sides. I, as seller, am only accepting a "no seller indemnity" option here or a limited seller indemnity option - an escrow of 1% or less. Your recourse as a buyer is going to be the insurance market. Call the broker listed on that process letter, ask them what work they've done Treat the quote however you'd like, and remarket it if you want. But that insurance option is going to be your recourse in this deal and the winning bidder will accept an insurance alternative."

Wang: Correct. And the PE funds obviously are the big players in that on the sell-side.

Heinz: Absolutely right. And the increased use of that seller flip model has actually led to a lot more corporate clients getting familiar with rep and warranty insurance now. That's because they have been through enough processes that they've either seen this approach or they've heard from investment bankers that they lost out on a given deal because some other bidder used rep and warranty insurance and gave the seller a sweetheart deal on indemnification. Those corporate clients are saying, "We have to get up to speed on this now, we have to understand how this works. And our deal team, our business development people, and our general counsel all need to get on board with how this works. We at least need to have the option of exploring this on future bids."

Negotiating the Policy

Romanek: Great. Jim, do you want to take us down to where the rubber meets the road - the negotiation?

Epstein: Sure. A lot of the things that we've been talking about have already hit this negotiation topic. So I'm going to skip over a lot of the things that we've already said and focus on some of the things that we really haven't talked about.

I'm going to start with the process, picking up on what Matt said. In auction situations, we are seeing some potential buyers, even strategics, coming in and saying they would like to use rep and warranty insurance as a negotiating ploy, to get a leg up in the process. That's something for you to think about as you're counseling your clients, particularly in an auction scenario.

When you get into the negotiation, there are really two sets of negotiations that we're talking about. One is with the carrier and some of the things that have been talked about already there. The other, assuming you're representing a seller, is the negotiation with the buyer. And we've talked about some things there as well.

There are a couple of things I'd like to point out. With respect to the amount of the deductible, or the retention, that the seller typically agrees to, assuming there is going to be some split to that, there often is a negotiation with the counterparty as to how you order that piece of the retention as compared to the retention that, in a sense, the buyer is picking up - whether one goes first, the other goes first, or there's some kind of sharing. So that is a point in negotiation that's out there for the purchase agreement.

In your indemnity section, for your defense of claims, recognize that typically these policies are set up so that the insurance company does not have any duty to defend, but has a participation right. So when you're thinking about how that impacts the purchase agreement rights to defend third party claims, you should just look at it such that the insurance company is in the background. They're not going to be taking a leading role.

We talked about types of damages. One of the benefits of this kind of policy is, if you are silent, you can typically get coverage for indirect, incidental and consequential damages, and even loss of profits and diminution in value. That avoids a negotiation over whether you're going to specifically include them or specifically exclude them.

One other thing which can be a bit of a trap for clients who have bought into the concept of using rep and warranty insurance as a seller is a buyer who has said "Yes, we'll do it," but who discovers a significant liability in the course of due diligence. That's because, as we talked about earlier in the program, that liability is a known liability. It's not going to get covered by the rep and warranty policy. As a result, you're going to find yourself having to deal with this issue separately, oftentimes in a special escrow.

So as you are counseling your clients with respect to this kind of insurance, keep that in mind. Make sure that the clients are aware of that situation so that they are not blindsided by it.

The other thing that, as a seller, you want to be cognizant of is the insurance company's rights of subrogation. I think it has shaken out pretty firmly at this point that it's typically limited to fraud. And when you're looking at the policy, even if you're the seller, you want to make sure you see at least that portion of the policy.

The last thing I wanted to mention that hasn't already been covered is the timing of when a policy gets issued. There are two ways to approach that. Assuming the transaction is a bifurcated transaction, such that there's a signing followed by a closing, oftentimes, you, as a seller, want the policy to be issued at signing and not at closing. There's a cost associated with that, or at least an upfront of the cost. I believe, Matt, it's still 10% of the cost you have to pay as a non-refundable deposit on it.

Heinz: That's right. So that will be paid at signing, with the remainder of the cost being paid at closing or shortly after closing.

Epstein: Yes. One of the good things about that is it typically removes any discussions or negotiations you have around conditionality. Oftentimes, people who are not used to dealing with these kinds of policies want conditions in the agreement that the policy gets issued, and you can find yourself having a conversation between buyer and seller on that. This is one way to avoid that.

Those are the negotiation points that we didn't otherwise cover that I wanted to mention.

Tax Indemnity and Contingent Liability Insurance

Romanek: Thanks very much. George, do you want to wrap it up with other types of insurance - tax indemnity and contingent liability?

Wang: Sure. Until now, we've been talking, in essence, about a policy that covers an unknown and unforeseen liability. The tax indemnity and the contingent liability policies instead deal with known and identified risks.

On the tax indemnity side, you can think of this insurance as an alternative to a private letter ruling from the IRS. These policies tend to cover matters such as the Section 338(h)(10) treatment of the deal, the ability to complete the transaction, spinoff or merger in a tax-free manner. It may cover other issues - retroactive changes in tax law and things like that. These

policies are negotiated with the underwriter to fit the specific needs of the parties and issues at hand. The cost tends to be somewhat higher than the typical rep and warranty policy.

You typically do not have to provide a law firm's tax opinion to obtain the policy. And these policies will cover the tax incurred, as well as interest penalties and potentially gross-ups.

There are certain areas where these policies are less common. For example, in the cross-border context, issues regarding transfer pricing tend not to be covered. Unless you've seen otherwise, Matt?

Heinz: We actually have done a few transfer pricing policies this year. It's really an ever-evolving area. I think you see these policies very frequently with spinoffs. You also see them with S-Corp issues - maybe there was second class of stock or something like that in a prior deal or distribution that could potentially blow S-Corp status.

Generally, the reason transfer pricing and things like NOLs are harder to get coverage for is because these are areas where you're asking an underwriter to bake into its risk transfer some analysis or acceptance of risk around a valuation, as opposed to around a bright-line tax position. That's more challenging for them.

For instance, in the NOL space, they have to look into the underlying strength of the NOLs and whether or not they were good NOLs when they were allegedly incurred. Or in a transfer pricing range, they have to look at underlying valuation issues.

But generally, we can get those done. They're a little bit more challenging. I would say the sweet spot for the carriers, on any tax issue, is about a "should" level of comfort and above. But really, for anything that's a "more likely than not" or above, it's worth giving us a call to see if we can do something.

These tax policies are most useful when you have a pretty low probability risk of running afoul of the IRS or of a state, local or international taxing authority, but the potential price tag tied to that misstep is humongous. Generally, a carrier is willing to address that outsized risk relative to a small probability through a tax policy. And as you mentioned, it's going to cover the actual tax paid, interest, penalties, gross-ups tied to taxes levied on the actual payment of the insurance proceeds, and potentially defense costs.

Most of these policies have - at least the good ones have - little or no retentions on them, because the risks are viewed as generally pretty binary. There may be some opportunity for settlement on some of these issues. But it's often possible to get a tax policy with a minimal or no retention. That's because the carrier is basically underwriting either getting it right or getting it wrong, as opposed to a rep policy, where you have a whole breadth of risks that can be covered, including small and large issues. So it's a pretty vibrant market.

One other note, George. Aside from tax-opinion-based risks, where you're addressing a specific issue, we also place a lot of insurance around tax credits, for any lawyers in the audience who are engaged in that space. We write them mostly in the renewable energy space. Basically, we can

provide insurance for the availability of a tax credit to a tax equity investor, built around syndication of the structure initially, as well as some of the go-forward risk with respect to availability of the credit over time.

Wang: Thanks, Matt. The other area is the contingent liability area. This can cover things like a pending litigation, where you're not asking the carrier to fully insure against the litigation but to perhaps ring-fence around a perceived maximum exposure in a litigation, so that claims in excess of a negotiated amount could be covered by insurance.