Using M&A insurance on tech deals

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McGILL AND PARTNERS

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orrick

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Since March 2020, over 80% of the deals McGill and Partners have advised on have been in the technology sector. Whether it is software as a service, enterprise risk management, fintech, or technology infrastructure, what is clear is that clients of both McGill and Partners and Orrick recognize the resilience of the sector and are continuing to pursue these deals. In this series of notes, we seek to highlight some of the factors that tech investors need to consider to maximise the benefits of M&A insurance. Our first issue focuses on some key considerations for most tech M&A, with subsequent editions diving deeper into specific sub-sectors.

Valuation

Valuations in the technology sector are unlike those in many other mature sectors, often taking account of the prospects and growth potential of the target.

Considering valuation early in the insurance process is crucial. Buyers should discuss how the target has been valued with their broker from the outset to ensure that the risk is matched with the right insurer and that the insurance protection appropriately recognizes the value of the buyer's investment.

IP, cyber and sub-sector specific diligence

Technology deals are each unique but share common differences from deals in other sectors. For the vast majority of these transactions, the importance of intellectual property (IP) and the risks associated with cyber breaches are both heightened.

In addition to IP and cyber, each technology sub-sector will have its own underwriting nuances. Over the coming weeks, subsequent issues in the series will look at structuring M&A insurance on deals in the following sub-sectors: software/SaaS, on-demand, connecttech, fintech, healthtech, artificial intelligence, gaming, educationtech, robotics and semi-conductor/manufacturing.

Policy and acquisition agreement structuring

Ensuring that the policy structure aligns with the acquisition agreement and overall commercial requirements of the buyer is key to maximizing the coverage available from an M&A insurance solution.

For buyers in technology transactions, typical areas of focus for policy alignment include coverage for share capital reorganizations, earn-out/deferred consideration, material adverse change provisions and the pre-closing tax indemnity.

There has also been an increase in the number of minority investments in the technology sector, where careful attention must be paid to the drafting of the policy mechanics to ensure cover works in a commercial way.

Valuation of a technology business

Tech M&A can often involve the acquisition of a relatively early stage business that may be pre-revenue but represents an attractive investment opportunity or an astute strategic acquisition for a buyer. The valuation methodology that has been applied will be a key area of underwriting focus for insurers as they seek to quantify the risk profile of the business. It is important to ensure that the policy will pay loss that recognizes the value to the buyer.

Articulating the valuation methodology and why it matters

For the purpose of valuing a business, a buyer will often use a multiple of EBITDA or future earnings. It may also be the case that the business is pre-revenue, with the value being assigned to the opportunity of exploiting certain elements of IP.

When a breach of warranty arises from a matter that will impact EBITDA or revenue of the target in the future, it is appropriate for that loss to be calculated recognizing the same expectation value placed when valuing the business in reliance on that warranty. So, if the loss reduces the EBITDA or revenue, the same multiple applied to the valuation should be applied to that recurring loss.

Many of the largest claims in the M&A insurance market have been quantified on the basis of multiplied damages.

Several M&A insurers will immediately exclude multiplied damage or potentially decline to provide a quote when it becomes clear that the EBITDA and revenue multiples of the target are above c. 20x and 4.0x respectively, or the business has negative EBITDA.

McGill and Partners will always seek to partner each risk with an insurer that appreciates the valuation of the business and the impact a loss will have on the value of the investment.

McGill and Partners recently helped a client obtain coverage on a transaction in which their valuation was c. 80x PY EBITDA.

What are insurers looking for?

Insurers will take comfort from a deal team that is able to demonstrate their expertise in the sector and their plans to scale the opportunity viably. Key considerations to bear in mind:

- Does the target have a unique application or product that is complementary to the buyer's existing offering? Does the existing team lack the necessary operational network to scale?
- Is the buyer focused on a very specific piece of IP that is owned by the target – if so, how has that been valued and how is it protected?
- What value is attributed to the material contracts with customers and suppliers and how secure are these?
- Are there comparable transactions for the target that support the valuation metrics the deal team is using?
- Is the financial due diligence thorough and does it provide quality analysis regarding revenue, cash flow and capex requirements? Insurers will have less appetite where the target has seen revenues decline consistently year-on-year. They will also want to examine projected future revenues.

Identifying IP liabilities

Insuring IP

As we increasingly move towards a digital economy, the value of intangible assets continues to rise. One of the fundamental drivers for technology M&A is for the buyer to take ownership of the target's IP. This can present an opportunity for the buyer to gain an immediate foothold in a new sector, add a complementary offering to their existing portfolio or even facilitate cost savings from owning the acquired IP rather than paying royalties to a third party.

The M&A insurance market is becoming increasingly adept at covering IP-related risks, whether by way of R&W/W&I insurance, general IP liability insurance in respect of go-forward risks or contingent risk solutions for identified IP issues. The importance of IP to a technology business cannot be overstated. For comprehensive coverage, a buyer must undertake thorough due diligence of the target's IP portfolio and be in a position to articulate the scope and value of the registered and unregistered IP to insurers.

General IP diligence

Insurers will want to understand the value attributed to the IP within the business and get a feel for the target's general approach to IP management and maintenance. Areas of focus will include:

- What do the target's general IP management processes look like?
- Are there written standards and/or procedures regarding the development and protection of IP?
- Does the target utilize specialist IP counsel (internal and/or external)?
- Are there any ongoing or historic disputes with third parties claiming the target is infringing their IP?
- Are there any ongoing or historic disputes with third parties concerning infringement of the target's IP?
- Have the IP assignment provisions with employees and contractors been the subject of diligence?

Registered IP diligence

Insurers will expect the buyers to have undertaken a customary review of any registered IP, which should include the following:

- What are the target's registered patents and trademarks?
- Has there been an assessment of any liens, security interests or encumbrances held by a third party over any target IP?
- Does the target issue any licenses to a third party in respect of any target IP?
- Has there been a review of any licenses the target has entered into to use any third-party IP including the target's compliance with the terms?
- Is the company solely responsible for manufacturing any products or components which are the subject of any patent or trademark?
- Are the IP rights held by the target sufficient for the buyer's plans for the business?

Unregistered IP

The level of diligence on unregistered IP expected by an insurer will depend on the nature of the target, its activities and the importance of its unregistered IP, but insurers are likely to expect a review to include an analysis of the following:

- Does the target have any copyrights and have these been reviewed?
- How does the target manage and protect its trade secret portfolio?
- What is the historic retention of key employees and contractors that are aware of trade secrets?
- What confidentiality agreements or restrictions are in place with employees and contractors that have left the business and are aware of the trade secrets?

Insuring IP risks

Effective use of M&A insurance solutions provides meaningful protection for the IP of a technology business

Representations and Warranties (R&W)/ Warranty and Indemnity (W&I) Insurance

An R&W/W&I policy will provide cover for IP representations/warranties given at signing and repeated at closing in respect of breach events that take place prior to signing and/or closing but are discovered after the policy has been incepted.

Insurers will typically provide full cover for representations/warranties that go to the target's ownership of registered IP, subject to relevant searches having been conducted.

It is common in Europe for insurers to require any representations/warranties that relate to third-party IP infringement claims to be knowledge qualified. In the US, we would expect to obtain full cover for representations that relate to the target's infringement of third-party IP and limit the knowledge qualifier to whether a third party is infringing the target's IP.

In the US (and to a lesser extent, in Europe) for an additional premium certain insurers are comfortable with treating the insured IP representations/warranties as fundamental representations/warranties for the purpose of the policy and with the option of taking a policy limit that gives protection for these important representations/warranties up to the full enterprise value of the target and extending the period of cover for up to seven years.

Intellectual Property Liability Insurance

Intellectual property liability insurance can be used to insure against financial losses suffered or incurred in connection with unknown infringement lawsuits and IP invalidation proceedings. The policy typically only relates to defensive proceedings, although certain offensive actions can be covered subject to diligence and additional premium.

Insured events are not tied to representation/warranty breaches and as such intellectual property liability insurance will provide cover on a go-forward basis (i.e. for insured events that take place after closing). Therefore, intellectual property liability Insurance can be a useful supplement to the IP coverage provided by an R&W/W&I policy when the IP portfolio is expanded following closing of the M&A transaction.

The policy is designed to protect the insured's IP portfolio as well as unique products and services. Cover can extend to both registered IP (i.e. patents) and unregistered IP (i.e. software). It can also be used to address indemnification claims related to a target's IP, products or services under contracts that the target might have entered into with parties such as licensees, licensors, customers and manufacturers.

Contingent Risk and Tax Insurance

Unlike R&W/W&I and specific intellectual property insurance solutions, a contingent risk policy can provide protection for known issues involving IP.

This highly bespoke solution is used in situations where there is a remote risk that a party may suffer financial loss in the event a known IP issue materializes, such as a pending IP dispute.

A specific tax policy can be used to address known tax issues such as a situation where there may be negative tax treatment from a tax authority where the domicile of an IP portfolio has been moved from one jurisdiction to another.

Contingent risk insurance and tax insurance can be used to release capital from balance sheets where risk can be allocated between parties who may not wish or not be able to retain the exposure. These policies are most effective where the chance of the identified risk materializing is deemed to be low, but the consequence of such event taking place would result in the policyholder incurring a significant financial loss.

Identifying cyber liabilities

Covering cyber risks

For the buyer of a technology business, the cyber resilience of the target should be a key area of focus. Whether it be destruction of IP, disruption of operating systems or the theft of customer or employee data, the financial and reputational damage that can arise from a cyber incident can be catastrophic. A buyer should look to both identify any potential cyber issues and put in place meaningful risk mitigation solutions.

Where the seller gives representations/warranties relevant to cyber matters under the acquisition agreement, it is possible to obtain a degree of cover under an R&W/W&I policy. But buyers should be aware that an R&W/W&I policy typically will not cover known risks or most losses arising from post-closing events. Often, the most prudent position for a buyer to take is to obtain maximum coverage under the R&W/W&I policy for unknown breaches arising prior to closing and specific cyber solutions in respect of post-closing events.

Target cyber due diligence

Insurers will expect the cyber diligence conducted to reflect the scale and vulnerability of the system and the likelihood of attack on a business of that type. Areas of focus will include:

- Has there been an analysis of the target's processes, tools and organization (including the sophistication of its cyber security teams and whether the target has a culture that centralizes and emphasizes the importance of cyber security processes and controls)?
- What is the extent of target-wide cyber awareness training and the processes and sophistication of board reporting?
- Have there been historic attacks or DNS attempts?
- What is the target's policy in respect of threat hunting exercises?
- Has there been a vulnerability review?
- Has there been compliance with relevant industry standards (e.g. FCA risk management standards, PCI DSS standards, Ofcom regulations, NIST, FINRA, HIPAA, FFIEC, etc.)?
- Is there any independent auditing or accreditation (e.g. ISO27001)?
- Has there been penetration testing of the target and its suppliers and do they carry out annual risk assessments?
- Has there been a review of firewalls?
- Have there been searches of the Dark Web conducted for signs of historic breaches?
- What is the target's threat detection capability and cyber incident response plan (whether there is a coordinated shutdown, wipe and rebuild policy, etc.)?
- Are there processes for auditing internal controls/insider threats?
- Is there segmentation of critical assets?
- Has an audit been conducted to check for active malware and whether the monitoring in place identifies anomalous events?
- Are there thorough incident reports for historic attacks and have these been remediated?

Third-party cyber due diligence

In cases where the target relies on a third party to provide outsourced services, insurers may expect similar due diligence to have been conducted on the third party and in most cases will want to understand what third-party vendor due diligence processes the target has in place. Insurers will look for security tools within the target's business, like Carbon Black and other SIEM software.

Insurers will also look to understand what contractual arrangements the target has in place (e.g. can they rely on a third party to indemnify the target for cyber incidents?).

Insuring cyber risks

Understanding cyber threats and putting in place protection against loss should be key areas of focus for the buyer of a technology business

Representations and Warranties (R&W)/ Warranty and Indemnity (W&I) Insurance

There may be several representations/warranties given under the acquisition agreement that are insured by the R&W/W&I policy that could be breached following the occurrence of a cyber event (e.g. adequacy of IT systems, GDPR/data protection).

An R&W/W&I policy will provide cover for insured cyber representations/warranties given at signing and repeated at closing in respect of breach events that take place prior to signing and/or completion but are discovered after the policy has been incepted.

Subject to an understanding of the cyber due diligence that has been undertaken, certain insurers can consider providing cover for cyber outright. Otherwise, (subject to underwriting comfort that the limit and coverage is adequate) the R&W/W&I policy can sit in excess of specific insurances that the target either already has in place or that are incepted post-closing with retroactive effect (such as cyber insurance or technology professional liability (PI)/error & omissions (E&O) insurance).

Cyber Insurance

Cyber Insurance provides specialist cover for liabilities and first-party costs associated with cyber risk, information and operational technologies. It operates on a modular basis which can be tailored to an insured's specific needs, covering:

- Data privacy and network security third-party liabilities.
- Business interruption loss resulting from a cyber security or system failure incident within the insured's network, or that of a third-party service provider.
- Incident response costs, including legal expenses and notification costs, IT forensics, PR costs, credit monitoring, ransom negotiation and demands and data restoration costs.
- Regulatory costs and, where insurable at law, fines and penalties.

As part of the incident response coverage, there is direct access to a panel of expert vendors on hand in the event of a cyber incident. Certain insurers also provide pre-loss risk management services such as incident response tabletops or threat monitoring services.

Technology PI/EO Insurance

Technology PI/E&O provides coverage for civil liability from professional errors and omissions associated with the provision of technology products and services, including:

- Negligence or breach of professional duty.
- Unintentional breach of contract.
- Breach of confidentiality or interference with privacy rights.
- Infringement of IP rights.
- Defamation, libel or slander.
- Work undertaken by contractors or outsourcers.

Often it is the case that a buyer will take out both a cyber insurance and technology PI/E&O policy or, more often, a blended program across the two in order to ensure that they have mitigated as much risk as possible.

Considerations for aligning the policy with the SPA/Definitive Agreement

Share capital reorganization

Many relatively early stage technology businesses will have undergone several rounds of growth funding with various options, loan notes and deferred shares being issued to founders, management and investors alike. Often a simplification of share capital is negotiated and arranged prior to completion of an acquisition.

For a complex restructuring of a more established business, European insurers would tend to expect a formal steps plan to be prepared; however, such a document will unlikely be available on most early stage tech transactions. We have been successful in getting both the corporate and tax matters related to these reorganizations covered in the absence of a formal steps plan by working with the buyer to understand the reorganization in detail and communicating this to the insurer. To obtain cover, it is important that the sellers set out clearly both the chronology of the steps that will be involved and the relevant corresponding contractual documentation, and that this is the subject of diligence with the findings accepted by the buyer's advisors. It is also possible in certain circumstances get coverage for a representation/warranty that is given only at signing in respect of the reorganization at closing despite its forward-looking nature.

Earn-out / deferred consideration

Performance linked earn-out mechanisms can be a feature of technology deals. While these can be structured in a variety of ways (e.g. linked to EBITDA or a specific commercial metric such as number of monthly users or subscribers), we suggest discussing the structure with the insurers as early as possible. It is important that the earn-out is not treated as a purchase price adjustment mechanism for the purpose of the policy (i.e. the insurer should not treat non-payment of the earn-out as a form of recovery for the insured that mitigates loss in the event of a warranty breach). The insured should be able to bring a claim for the full amount of loss suffered, regardless of the non-payment of the earn-out.

Where the buyer has agreed to pay a portion of the purchase price post-closing (whether performance related or otherwise), consideration needs to be given to the enterprise value that the insurers use for the purpose of the policy and the valuation for the purposes of any loss calculation in the event of a claim. Should it be based on the enterprise value at closing or on the total enterprise value including the future deferred amount? Insurers have differing views on which approach to take but attention must be paid to the insurance structure selected as it will impact the policy limit, applicable retention, pricing and, ultimately, recovery.

Material adverse change ("MAC") provisions

Given the uncertainty caused by the COVID-19 crisis, we have seen an increase in the attention paid to MAC provisions in the transaction documents to afford the buyer the right to walk away in the event of certain specified issues arising between signing and closing that impact the financial situation of the company.

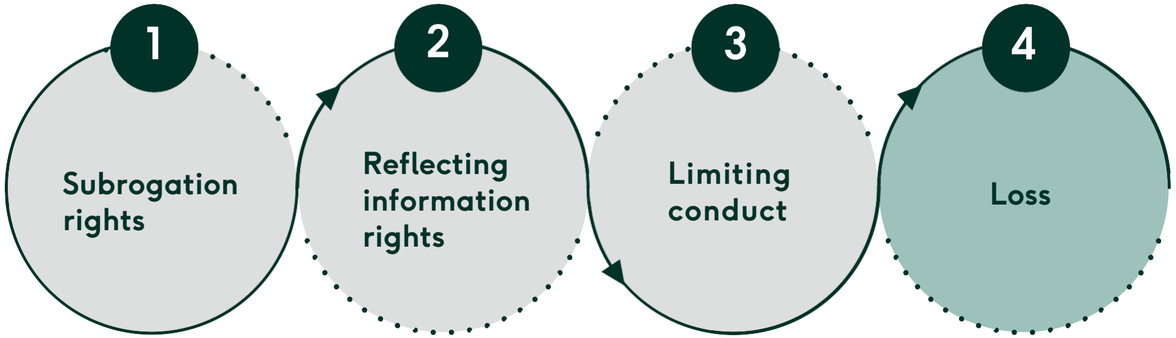
While this is valuable protection for the buyer, it is important to bear in mind that M&A insurance cannot plug this gap. If a MAC event occurs and/or is discovered between signing and closing, the insured cannot proceed with closing and subsequently rely on the M&A insurance to provide relief post-closing, as insurers will expect the insured to rely on this contractual protection. In this case, the buyer may renegotiate the deal or can decide to proceed with the deal. However, no cover will be afforded under the policy for issues arising from the facts that triggered the MAC provisions.

Using M&A insurance to facilitate a minority technology investment

In recent years, it has become increasingly common for financial sponsors and corporates to take minority positions in early stage or established technology businesses. In the post-COVID era, we anticipate that the number of minority investments will continue to increase as private companies seek capital funding to weather the storm while looking to retain some control of their business or capitalize on opportunities for growth.

M&A insurance is particularly suited to minority investments, where the ability to pursue management in the event of a breach of a warranty may not be practicable. It can also be used where the investment is made by way of an instrument other than common or preferred equity such as debt financing. Structuring insurance thoughtfully in these cases is important.

There are a number of factors to consider when structuring insurance on a minority technology investment



- Limiting the insurer's subrogation rights so that they cannot pursue management and cannot pursue customers or suppliers of the target until a threshold is exceeded.

- Ensuring that the information requirements in the policy (e.g. timing of notification of a claim) reflect the information the buyer will receive.

- Limiting the rights an insurer has to interfere with how the business handles claims.
- Ensuring that the policy does not require the insurer to pursue other insurance policies.

- Ensuring that the calculation of loss reflects the impact to the buyer's investment (including any multiples), not just the loss to the business (noting further that loss will usually be paid to the insured on a pro-rata basis in line with the investment amount).

M&A insurance to preserve relationships

A common feature of technology deals is for management to roll a portion of their equity into the new business, and our clients typically look to form strong partnerships with the rolling members of management as part of their investment strategy.

Avoiding conflict with management

The insight and expertise of management can be crucial for the success of the newly acquired business going forward and as such it is imperative that a strong working relationship is maintained. In this instance, M&A insurance can become an incredibly valuable relationship preservation tool. By providing the buyer with recourse against an A-rated insurer, management can give representations/warranties to the buyer under the acquisition agreement on a no-recourse (or limited recourse) basis.

In the case of a no-recourse transaction, if an insured representation/warranty is breached, the buyer can bring a claim directly against the R&W/W&I insurer. Running a claims process with an insurer is considerably less disruptive than starting an adversarial process with the management team. Where issues arise, interruption can be minimized and relationships can be maintained. The buyer can be compensated for its loss, while the management team is able to focus on running and growing the business

In the event of a breach of a representation/warranty given by management, M&A insurance allows a buyer to pursue a claim directly against the insurer.

The bolder your ambition, the better we become.

If you would like to discuss how to get the most from M&A insurance on an upcoming technology deal, or to find out if we can use our expertise and creativity to help you to resolve any other transaction issues, please contact **sam.murray@mcgillpartners.com**

Orrick co-authors:

Peter Lamb | plamb@orrick.com
David Ruff | druff@orrick.com
Hari Raman | hraman@orrick.com
Daniel Lopez | dlopez@orrick.com

About us

McGILL AND PARTNERS

Launched in 2019, McGill and Partners is a boutique specialty risk firm created by some of the most well-regarded leaders in the insurance industry. We provide best-in-class advice and independent judgment on the most complex transactions to capitalize on fast moving opportunities and achieve tailored, creative solutions. Members of our M&A group have worked with 9 of the 10 biggest[1] Private Equity firms on some of the highest-profile M&A insurance solutions and claims in the market. Our deal-seasoned team has unparalleled cross-border M&A insurance broking and underwriting insight in North America, EMEA and Asia-Pacific regions.

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Orrick provides strategic legal advice for companies in the Technology & Innovation sector with over 2,700 technology clients worldwide, including 20% of the $1 billion+ unicorns. Our integrated, cross-border M&A team of 150 lawyers in 25 markets counsels some of the world's leading public and private tech companies on strategic buy-side and sell-side M&A, and private equity funds and their portfolio companies on M&A and growth equity transactions. Orrick is consistently ranked as a Top Five law firm for M&A deal volume by Bloomberg.

[1] Size according to Private Equity Investor, based on capital raised over the last five years.