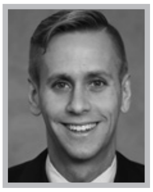
Published by Financier Worldwide Ltd

ROUNDTABLE August 2020

MANAGING TRANSACTIONAL RISK

All M&A transactions, whatever their value and volume, should be subject to rigorous legal, tax and financial due diligence, in order to fully assess the target. Each acquisition is unique, and transactional risk management must take into consideration the goals, facts and circumstances of the deal. With COVID-19 adding new challenges, buyers will look to mitigate potential risks and liabilities before closing. As a result, the appetite for M&A insurance will continue to rise. ■

THE PANELLISTS



Elliot H. Kowalski
Vice President, AIG
T: +1 (212) 458 5468
E: elliot.kowalski@aig.com
www.aig.com

Elliot Kowalski is vice president, M&A insurance for North America general insurance at AIG. He joined AIG in 2015 as a senior M&A underwriter, where his primary focus was underwriting representations and warranties insurance. Prior to joining AIG, he was an associate at Fried, Frank, Harris, Shriver & Jacobson LLP for over six years. Mr Kowalski holds a J.D. from the University at Buffalo Law School, manga cum laude, and was a member of the Buffalo Law Review.

Marc B. Sherman
Managing Director, Alvarez & Marsal
T: +1 (202) 729 2129
E: msherman@alvarezandmarsal.com
www.alvarezandmarsal.com

Marc Sherman is a managing director and partner with Alvarez & Marsal, resident in Washington, DC. He specialises in forensic accounting, corporate restructuring and transactional insurance. His clients include many of the larger transactional insurance carriers and underwriters in the US and Europe. He is a certified public accountant and member of the bar and frequently serves as an arbitrator in post-acquisition M&A disputes.

Michael Wakefield
Senior Vice President, CAC Specialty
T: +1 (404) 721 6166
E: michael.wakefield@cacspecialty.com
www.cacspecialty.com

Michael Wakefield leads the transactional insurance practice at CAC Specialty, which negotiates and places representation & warranty, tax and contingent risk insurance policies, and advocates for coverage on behalf of its clients. He previously practiced law at King & Spalding LLP and clerked on the US Court of Appeals for the Fifth Circuit. He holds a J.D. from the University of Texas School of Law.

Jay Rittberg
Managing Principal, Euclid Transactional
T: +1 (646) 517 8808
E: jrittberg@euclidtransactional.com
www.euclidtransactional.com

Jay Rittberg is managing principal of Euclid Transactional, LLC. Prior to joining Euclid, Mr Rittberg was senior vice president and Americas M&A manager at AIG, where he was responsible for managing the development, underwriting and marketing of transactional insurance products. He was also previously a corporate attorney at Schulte Roth & Zabel LLP, where he advised clients on a wide range of corporate matters.

Brian Hendry
Head of Mergers & Acquisitions, Paragon International Insurance Brokers Ltd
T: +44 (0)20 7280 8276
E: bhendry@paragonbrokers.com
www.paragonmanda.com

Brian Hendry is head of M&A insurance at Paragon. He is a career insurance broker with over 30 years in the industry and since the late 90s has focused exclusively on M&A insurance. He has been closely involved in the evolution of the M&A insurance market and has helped it develop from a niche product to something that is now considered on the majority of transactions.

Toria Lessman
Senior Vice President, Head of Professional Lines and Industry Verticals, QBE
T: +1 (312) 803 3518
E: toria.lessman@us.qbe.com
www.qbe.com/us

Toria Lessman is the senior vice president responsible for QBE North America's professional lines business, industry verticals and transactional liability practice. She oversees ongoing development and execution of the company's strategic direction in these areas with a distinct focus on underwriting, portfolio management, distribution and enhancing the customer experience. Ms Lessman has held several leadership roles at QBE with increasing responsibilities, serving most recently as SVP, head of transactional liability.

Nuala Read
Transaction Risk Insurance Manager UK, Tokio Marine HCC
T: +44 (0)20 7648 1309
E: nread@tmhcc.com
www.tmhcc.com

Nuala Read is based in London and leads Tokio Marine HCC's UK transaction risk insurance (TRI) team, offering tailored insurance policies for M&A deals. She is ACII qualified with over 20 years of insurance experience. Before joining Tokio Marine HCC in 2017, she worked within Aon's M&A team for 15 years, with a career focus on the placement of specialist TRI products for hundreds of M&A deals.

Sammy Shihab
Partner, Transact Risk Partners LLP
T: +31 6 41 21 52 72
E: sammy.shihab@transactriskpartners.com
www.transactriskpartners.com

Sammy Shihab is the founding partner of Transact Risk Partners LLP (Transact). Based in Amsterdam, Transact is a managing general agency specialising in warranty and indemnity insurance for M&A transactions within Western Europe, and global tax risk insurance. Since 2017, Transact has insured over 300 deals within Europe.

FW: As part of transactional risk management, what key areas need to be considered during due diligence?

Kowalski: There is no 'one size fits all' approach to due diligence. Buyers should engage experienced outside advisers or have an internal team that understand the industry in which the target operates to help with the process. Those advisers know where to concentrate their investigation to identify risk, including by focusing on accounting, tax, employees, compliance with laws, contractual relationships, intellectual property (IP), regulated aspects of a business, among other key areas. Additionally, limitations on due diligence from travel restrictions or otherwise should be considered by buyers at the outset because coverage may be narrowed as a result, such as when the condition of assets cannot be inspected, or Phase I reports cannot be completed.

Wakefield: It is no secret that thorough legal, tax and financial due diligence is paramount to fully assessing key risks associated with most targets. Depending on the target's industry, a buyer may also need to pay special attention to other areas, such as information technology and data privacy, IP, environmental, insurance and regulatory compliance. If a buyer is utilising representations and warranties (R&W) insurance – and thus asking an insurer to step into the seller's shoes and indemnify the buyer for unknown breaches of the seller's representations and warranties – then the underwriter will want to see that the buyer's diligence sought to confirm the accuracy of those representations and warranties.

Lessman: In most deals, tax, financial and benefits and employment matters should all be considered during due diligence. Corporate matters including capitalisation and authority should also be reviewed. Depending on the sector of the target company, areas such as regulatory, food safety and cyber security and data protection should also be considered. If the target company is involved in manufacturing, environmental diligence should be conducted as well.

Read: From a warranties & indemnities (W&I) insurance point of view, there are two areas that must undergo comprehensive due diligence: financial statements and taxes. Of course, depending on the business profile of the target, there are other important areas that need to be defined and examined appropriately. There may be many valid commercial reasons for deal parties to undertake a light touch or red flag-style investigation, however, this can cause issues, especially when the level of information available does not match insurance coverage requirements. Generally speaking, the widest level of cover for the deal warranties can be given when these have been thoroughly considered by the buyer. It must also be said that the coronavirus (COVID-19) pandemic is currently impacting all areas of life and, as a consequence, there is an increased expectation that buyers will look to mitigate this risk in the deal. From an underwriting perspective, we would expect their focus to be on this risk in relation to supply chain, customer relationships, material contracts and workplace health.

Hendry: The core aspects – legal, financial and tax – and obvious sector specific diligence requirements that arise from each deal need to be considered. We expect to see an uptick in cross-border M&A activity as private equity firms in particular look to deploy their capital following a brief hiatus as a result of COVID-19. On such transactions, and in light of COVID-19, the scoping of both buyers and sellers due diligence needs to be thought through, including the geographical spread of the target business and the market where any insurance may be placed. Policy terms and conditions will have a bearing, for example European W&I markets generally accept lower excess levels in their policies but may include a *de minimis* related to materiality in diligence reports. Accordingly, underwriters can expect due diligence to consider the vast majority of jurisdictions in which a target operates unless they are *de minimis* in the context of the overall business.

Rittberg: From a commercial perspective, deal insurers always try to understand the buyer's strategic rationale for a deal and why there is an interest in making the deal. Specifically, we expect deep financial, operational and customer and supplier due diligence. From a legal perspective, we expect comprehensive corporate, tax, employee benefits, environmental, IP and regulatory diligence. We continue to see an increase in cross-border transactions which may require local expertise, including international trade, corruption and bribery due diligence. COVID-19 has added new challenges, including how to access facilities and personnel, and understanding what constitutes reasonable due diligence in this age of Zoom.

Shihab: From a transaction insurance perspective, it goes without saying that robust diligence in areas of legal, financial and tax will always go a long way to achieving strong policy cover. Commercial due diligence is always useful to assist with an insurer review. By equipping the insurer with the commercial fundamentals and know-how of the relevant transaction, this allows an insurer to more frequently make positive insurance cover judgement calls.

Sherman: Transaction activity in the information technology space, such as software, cloud-based applications, artificial intelligence, software as a service and other technologies have continued to grow significantly over the past six or seven years, rising to new levels annually, both in quantity and value. These types of transactions present new challenges in diligence because of their unique technological characteristics and require new technology proficiencies and related diligence skillsets.

FW: What are some of the common issues that surface post-close, which could have been detected or avoided with adequate diligence?

Wakefield: Issues can arise from just about anywhere – which is why diligence is so important. That said, some issues are more frequent and severe than others. One example involves errors in the target's financial statements, which are often discovered by a buyer during the first post-closing audit. Such issues can quickly become material, especially where the buyer calculated its purchase price by reference to a multiple derived from the target's financial statements. To oversimplify, if a buyer paid eight times as much earnings before interest, taxes, depreciation and amortisation (EBITDA) for a target, and post-closing discovered an error in the financial statements resulting in a $2m decrease in EBITDA, the damages to the buyer would be $16m. We have also seen large R&W claims resulting from the buyer's diligence failing to identify certain taxes owed, to discover flaws in the condition of assets, to accurately disclose material contracts, and to accurately account for the target's liabilities, among others.

Lessman: Some buyers do not perform thorough diligence regarding wage and hour law compliance because it is a very fact-intensive analysis. Misclassification of employees or failure to properly pay employees can result in class actions with millions of dollars of liability. These types of issues could be uncovered by thorough diligence and setting up appropriate policies and procedures at the outset. On the tax side, there are often sales and use tax compliance and filing issues that could have been identified in a tax report performed by an accounting firm. Given how common nexus issues are, unless the target is truly only operating in one or two states, without a tax report identifying the states where the target may have nexus, they could be hit with a tax bill post-closing.

Read: In the last 10 years, issues surfacing post-closing have been an area of focus as we have dealt with resulting claims. Interestingly, while most of our claims notifications were for tax matters, the majority of claims paid were regarding financial statements and their incorrect or inconsistent application of accounting rules for recording profit, stock, debts or depreciation. This should not be a surprise as W&I covers the diminution in a target's share value and most business issues will likely impact the valuation of the target. As such, this has now become an important area taken into consideration when underwriting.

Hendry: Roughly 20 percent of W&I and R&W globally have claims notified on them. The bulk of these relate to four areas: financial statements, tax, material contracts and compliance with laws. Unsurprisingly, these are areas of heightened underwriting focus which carriers expect to be supported by fulsome due diligence. Often, however, additional due diligence would not have uncovered the matter giving rise to the notification. Instead, the notification is often the result of insufficient disclosure by the warrantor, either innocently or fraudulently. Buyers should ensure that the individuals involved in the disclosure process are sufficiently engaged, notwithstanding their limited liability under the acquisition agreement.

Rittberg: Over the past few years, firms have paid millions in claims on insurance policies and a large portion came from undisclosed breaches related to financial statements or undisclosed liabilities. The most significant payments do not appear to have arisen from a lack of due diligence but rather through communication issues or unexpected third-party claims or actions. In some cases, fraud at the target may contribute to the issue, but well-hidden fraud is often difficult to find, even with the best due diligence. We have seen a few smaller claims related to technology licensing that could perhaps have been identified in due diligence but, depending on the deal, such issues may fairly be determined to be immaterial. We always require completion of adequate due diligence before providing insurance coverage, but there are lots of different ideas about what 'adequate' due diligence means.

Shihab: Non-disclosure of commercial contracts seems to be an increasing deal and insurance claims issue. We definitely see a trend in this area. For 2019 and 2020 it is our most frequent

"NON-DISCLOSURE OF COMMERCIAL CONTRACTS SEEMS TO BE AN INCREASING DEAL AND INSURANCE CLAIMS ISSUE. WE DEFINITELY SEE A TREND IN THIS AREA."

SAMMY SHIHAB
Transact Risk Partners LLP

warranty breach scenario, whereas it used to be accounting and tax issues. I do not think it is a coincidence that this is occurring against a backdrop of more high level and red flag legal due diligence exercises. The M&A landscape has shifted to a more concise and targeted due diligence reporting format. Overall, this is a positive trend for the industry. The existing practice of providing 200- to 300-page reports now feels archaic. That said, adequate scope should still be given to robust document review to reduce the trend of non-disclosure issues.

Sherman: Two of the more common issues that we see surfacing post-closing that may have been avoided or detected pre-closing relate to financial statement irregularities and the surprise condition of some customer and contractual arrangements. On the financial statement side, unaudited historical financial statements increase the risk profile and may lessen the reliability of financial information and therefore should raise misgivings and lead to enhanced due diligence measures. Those measures take extra time and effort but can pay big dividends. Other observed idiosyncrasies in financial and accounting management, like a complicated or sizeable target using less sophisticated, small company accounting software or a consumer products company with no warranty reserve, should be a warning and also met with enhanced due diligence. Most transaction agreements represent that all customer relationships are healthy and that material contracts are secure. However, in my experience, there are a disproportionate number of post-closing discoveries of pre-closing customer or contract problems. Many of those problems may have been discovered through more probing and penetrating due diligence. Conducting diligence calls with all material customers and inquiring of those customers about the current state of business relationships, pricing structure, forecasts and contractual requirements is essential and can help acquirers better understand relationships with material customers, manage the risk associated with those customer relationships and detect issues prior to closing.

> "WE CONTINUE TO SEE A GROWING APPETITE FOR R&W AS PARTIES BETTER UNDERSTAND THE BENEFITS THE INSURANCE OFFERS."
>
> TORIA LESSMAN
> QBE

Kowalski: R&W claims covering a variety of issues are becoming more frequent and larger. Some, but not all, of these would be avoided through due diligence. Breach types such as financial statements, taxes, compliance with laws and material contracts seem to be continuing to drive the claims notifications. Companies should take no shortcuts when it comes to these and other areas of due diligence as the frequency and severity of claims continue to rise. For instance, for material customers, diligence should delve into those customer relationships, immaterial jurisdictions should be reviewed for tax implications, and the condition of machinery and equipment should be inspected for functionality.

FW: Are you seeing a growing appetite for M&A insurance, to help manage risks and see deals through to completion?

Lessman: We continue to see a growing appetite for R&W as parties better understand the benefits the insurance offers. While historically the insurance has been used predominantly by private equity, we have seen growth with strategic corporate buyers. In addition, we have seen the insurance used more in smaller deals than in the past.

Read: Since 2010, the use of M&A insurance has increased exponentially, expanding from being mainly used in private equity buyouts to all types of deals. Most importantly, M&A insurance is now used by many different types of buyers and sellers, not just private equity professional investors. With this growth has come increased understanding of not only the advantages, but also the limitations of the product. Currently, the UK and European M&A insurance market is highly competitive. As such, the product is likely to continue to evolve and offer cover that helps clients manage deal risks as effectively as possible.

Hendry: The understanding and use of products by the global M&A community has been growing consistently across all geographies and sectors, and the insurance market has rapidly expanded to meet the demand. We have seen two and threefold increases in the number of firms offering products, and specialist M&A insurance practitioners are being hired from law, accounting and other traditional M&A roles to meet this demand for insurance products. The combination of experience from over two decades of M&A insurance underwriting, rapid growth and ever-increasing competition for business is ensuring that M&A insurance experts are available to assess most transactions, regardless of size, sector or geography.

Rittberg: For the past few years we have seen double-digit growth in the percentage of policies sold and M&A insurance has now become common on middle market private M&A deals. We attribute this growth and acceptance to proven payment of claims and a smoother process to obtain the insurance. Even during the downturn from COVID-19, we saw continued use of insurance, albeit on a smaller number of deals getting done, and an uptick in requests for insurance with deal volume now increasing. We see this increase in appetite in many countries and increasingly deal advisers are comfortable recommending deal insurance to shift unknown risks away from buyers and sellers to insurers that are used to paying claims.

Shihab: We continue to see increased use of M&A insurance, even as the product has become quite mature, and in some areas commoditised. For 2019 and 2020, there has been significant growth of the product throughout mainland Europe. For jurisdictions such as Belgium, France and Central and Eastern Europe, M&A insurance has moved from a product used mostly by UK and US inbound bidders, to something widely adopted by domestic parties. What are we experiencing so far in the COVID-19 environment is that while there are fewer M&A transactions, the proportion of insured transactions has increased. The new risk environment, along with a forecasted return to more normal M&A levels in Q3 and Q4 2020, should result in continued growth for M&A insurance usage.

Kowalski: M&A insurance has become a significant feature in facilitating the closing of M&A deals over the past five or so years. An influx of insurance capacity led to lower prices and expanded coverage and some carriers began to build a track record of paying claims during this time. But with claims payouts becoming more frequent and severe, premium rates have started to climb closer to historic rate levels to account for the increasing claims, even though some carriers are still trying to differentiate themselves based on unsustainable pricing due to a lack of claims experience. It is important to place an M&A policy with a carrier that has significant experience, has handled lots of claims and will be around for the long term, as these policies have long tails.

Sherman: M&A insurance has become the preferred vehicle for risk allocation in M&A deals. There has been a continued year-over-year increase in the number M&A policies issued and the use of M&A insurance to manage and share risk. The entire industry has experienced exponential growth in the past half-decade, which has also translated into an increase in claim submissions and recoveries in more recent years. In addition, M&A insurance has become a favoured vehicle to de-risk deal structures for investor sellers, and is often a mandated component of today's deals.

Wakefield: We are seeing rapid growth in three types of M&A insurance. First, R&W continues to expand into new corners of the M&A world. Parties use R&W in industries and contexts where market appetite was previously viewed as limited or non-existent, such as distressed transactions including bankruptcy 363 sales, healthcare, energy including upstream oil and gas, financial institutions and services, among others. Second, the tax insurance market is growing even faster. While tax insurance can also be used outside of M&A transactions, it increasingly facilitates M&A negotiations by addressing 'deal-breaker' known tax risks and allowing the parties to avoid negotiating a separate tax indemnity or escrow. Third, the market's appetite for other 'known' risks also continues to expand. More than ever, we are able to transfer the risk of known litigation or other contingent risks to insurance, often providing a path to closing in an otherwise threatened transaction.

FW: 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?

Read: Competition among insurers is a significant trend we are seeing in Europe for W&I insurance, resulting in

"SINCE 2010, THE USE OF M&A INSURANCE HAS INCREASED EXPONENTIALLY, EXPANDING FROM BEING MAINLY USED IN PRIVATE EQUITY BUYOUTS TO ALL TYPES OF DEALS."

NUALA READ
Tokio Marine HCC

the widening of insurance cover. It feels like a 'golden time' for clients in terms of availability of increased cover, wider terms and reduced pricing, at least in terms of the European M&A insurance market. For many years, W&I was highly profitable with a low number of claims. This might explain why many new insurers recently entered the market. However, evidence is building that, as the use of the product grows, more claims are being made and payments are increasing. All of this highlights that ever-expanding cover and cost reductions will not last forever.

Sherman: M&A insurance offerings have evolved over the last several years to allocate more of the risk to the insurers with provisions like materiality scrapes.

Shihab: Since COVID-19, there has been a shift in parties' attitudes to using M&A insurance. Before COVID-19, we were in a strong seller market, which meant the principal focus of M&A insurance was to be a transaction enabler, while also reducing the seller's residual liability. Post COVID-19, these considerations are still essential, though as we have moved to a buyer-led process there is greater focus on broader insurance cover and enhancements. It is now quite common for an M&A insurance policy to include synthetic cover items, interim breach cover and additional tax affirmative cover items. It is quite exciting to see the product innovate throughout this period to enable transactions in a trickier M&A market. Pricing of M&A insurance has decreased throughout 2020 and will likely continue to do so for the remainder of the year. However, we expect that from 2021 pricing should stabilise and potentially even increase as the effects of the hardened insurance market start.

Wakefield: Beyond R&W trends, there have been developments in tax and contingent risk markets – where we view notable recent trends as justifying heavy investment. In tax insurance, we have quickly gone from a count-on-one-hand number of primary underwriters to 15-20. Minimum rates had been in the mid-single digits. Now, for some risks, rates can be under 2 percent. Rates for 'riskier' tax risks remain higher, reflecting the market's growing sophistication in tackling a variety of issues. Both underwriters and brokers have staffed up dedicated tax teams to efficiently transfer an expansive range of tax risks to insurance. Even more recently, market appetite for contingent risk placements has begun to dramatically expand, following some of the same growth patterns as the tax markets.

Kowalski: No one can deny that losses are not just becoming more frequent, but also more severe. Some firms are taking significant steps toward making sure pricing, terms and conditions are aligned with an insured's due diligence practices and keeping pace with loss trends. A push for increased rate is necessary to help ensure the long-term sustainability of the M&A insurance market.

Rittberg: Over the past decade, policy terms have improved for insureds, including, importantly, a broader definition of loss, often allowing for diminution in value and multiplied damages when appropriate, reduced pricing and deductibles, and better language related to handling of insurance claims. The insurance has been accepted as an attractive alternative to seller indemnity and sometimes offers broader coverage than sellers have provided in the past. With more law firms negotiating template policies with M&A insurance providers, policies can also be obtained more quickly than ever and are used in even the fastest-moving transactions. In the past 18 months or so, with more claims paid than ever before, we are seeing an increasing focus by insurers and reinsurers on pricing risk appropriately, and expect that rates will rise as deal volume picks up into 2021 and beyond.

> **THE UNDERSTANDING AND USE OF PRODUCTS BY THE GLOBAL M&A COMMUNITY HAS BEEN GROWING CONSISTENTLY ACROSS ALL GEOGRAPHIES AND SECTORS, AND THE INSURANCE MARKET HAS RAPIDLY EXPANDED TO MEET THE DEMAND.**
>
> BRIAN HENDRY
> Paragon International Insurance Brokers Ltd

Hendry: Looking at the markets outside of the US, toward the end of 2019 and the start of 2020, we were experiencing strong competition between insurers to win business, with the positive for the insurance buyer of lower premiums and policy retentions, plus general expansion of coverage. Insurance was regularly an intrinsic part of a transaction, and within the acquisition agreement the warrantor's protection would be enhanced through a cap of contractual liability or knowledge-qualified warranties across the board. As is the case across much of the M&A marketplace, COVID-19 has materially reduced the number of transactions and, in turn, those seeking M&A insurance.

The immediate impact has been to intensify competition between insurers, leading to further softening in pricing and broadening of cover.

Lessman: Over the last few years, pricing and coverage has become more attractive. The coverage is aligned with the transaction and may assist in allowing the deal to close quicker.

FW: How important is claims experience when it comes to dealing with a breach and achieving a swift and efficient resolution?

Hendry: As the severity of claims under W&I and R&W policies continues to increase, a swift and efficient claims resolution can be critical in ensuring the survival of an affected business. Accordingly, the claims process which an insurer offers alongside prior claims history and experience is one of the key discussion points when an M&A team advises clients on which carrier to appoint as underwriter on a transaction. A combination of factors, including increased claims activity across the broader insurance industry, increased W&I and R&W claims frequency and severity, and a sharp decline in M&A activity due to COVID-19, may challenge the existence of certain carriers. Given the lengthy survival period of these policies – seven years from transaction close – it is important that buyers consider, and are comfortable with, the resilience of their counterparty.

Wakefield: Some newer insurers, eager to establish a claims-paying track record, have sprinted toward fast, full payments. But a lack of experience could also slow things down if, for example, the insurer must spend more time educating internal constituents. On the other hand, some long-established players have developed well-organised claims processes. An insurer that has seen numerous claims may leverage that experience to expedite the fact-intensive work of assessing losses and can help the insured mitigate losses in a third-party claim, such as litigation or a tax audit. It is also worth noting that many insurers seek to level this playing field by 'outsourcing' experience to experienced advisers who have counselled various insurers in resolving many claims. Finally, although it is frequently overlooked, broker experience with claims can also facilitate efficient resolutions.

Shihab: While M&A insurance can be a fantastic deal facilitator, the claims process needs to be equally smooth for parties to have confidence in the product. Typically, a warranty breach entails many moving parts, and many parties' interests are affected. Claims experience is needed to bring a resolution to keep all parties happy. We have found that a key to expediting M&A claims is the continued involvement of the insurance underwriter in the claim. That person has the background to the transaction and can bypass a lot of work in being part of the claim review process. As the level of valid claims increases in the market, claims experience should be considered equally with insurer execution and coverage.

Kowalski: A carrier sharing its claims experience with insureds can help them improve their process. When facing a loss, buyers and sellers want to work with an in-house specialist claims team with multiple years of experience in handling M&A claims. Each deal is individually negotiated with a number of different factors that can come into play. The carrier, at an information deficit, will focus on asking the necessary questions and hiring knowledgeable advisers to help resolve claims. However, once it has the required information, it is better prepared to handle a claim without the emotion that a seller may have when they are alleged to have made an inaccurate representation.

Rittberg: Claims experience is tremendously important to achieve efficient resolutions. M&A insurance claims often include complex legal, accounting and valuation issues related to breach and loss. From working on hundreds of claims, firms recognise certain patterns and pitfalls in processes that should be avoided in order to help create a smoother and more collaborative process with insureds and their advisers. Large data sets show how quickly claims are submitted and resolved. Data for team building and hiring and training claims adjusters are also useful, so that appropriate resources can be deployed to effectively handle the claims that insureds will make on hundreds of policies each year.

> "SOME NEWER INSURERS, EAGER TO ESTABLISH A CLAIMS-PAYING TRACK RECORD, HAVE SPRINTED TOWARD FAST, FULL PAYMENTS. BUT A LACK OF EXPERIENCE COULD ALSO SLOW THINGS DOWN."
>
> MICHAEL WAKEFIELD
> CAC Specialty

Lessman: Claims experience is an integral part of the coverage process. Claims are more frequent, and insurers are paying valid, covered claims. The claims process differs depending on the representation that is breached.

Sherman: Claims experience is vital – both on the insurer side and on the policyholder side. When the insurer has deep experience, it promotes a more efficient and effective process, honed through that experience, to validate and resolve the claim. But, experience and knowledge of M&A insurance and related claims are just as important on the policyholder's side. Many policyholders, not surprisingly, have little understanding of and experience with the claims process or coverage, and consequently hire, or should hire, advisers and counsel. Importantly, related M&A transaction insurance experience of those advisers is very critical. Policyholders, at times, hire advisers who are not sufficiently insurance savvy or not steeped in transaction insurance and the claims process. The claims process is designed to be collaborative between the insurer and the policyholder and advisers inexperienced in M&A claims often take more of a litigation and non-cooperative approach. This does not well serve either party in the process, or the process itself. Every claim deserves an efficient and thoughtful validation process through experienced insurer and policyholder collaboration.

Read: It is well known that the first W&I claims were painful. The insurance market was slow to understand that W&I claims were different to other types of insurance claims. Retrospective evaluations also noted that many clients made W&I claims with little or no supporting evidence. As W&I claims continue to increase, appreciation is building for the benefits of claims experience. Some M&A insurers have built up solid in-house expertise, offering a dedicated and professional claims service to meet the expectations of the M&A community. The advantages of an experienced claims team, that has negotiated and paid multi-million W&I claims, cannot be overstated for this type of insurance. For clients that have had W&I claims, it is the key differentiator in their insurer selection.

> "CLAIMS PAYMENT IS AS IMPORTANT AS DEAL EXECUTION AND ACQUIRERS SHOULD WANT TO KNOW WHO STANDS BEHIND THEIR POLICIES."
>
> JAY RITTBERG
> Euclid Transactional

FW: What essential advice would you offer to acquirers on how to properly manage transactional risk?

Shihab: There is no such thing as overcommunication. Communicate as early as possible what is important to you in the transaction and resulting insurance process. Mid-process, the insurance policy cover should only reduce outliers. Both parties' expectations should be set at the beginning, so the adviser can clearly outline the cover requirements. It does not hurt to ask. Transaction insurance can increasingly diverge from the underlying transaction process. Just ask the question and see what idea the insurer can propose. Identify early in the process any material transaction risks and discuss these with your broker and insurer to set expectations on what is coverable. In the event something is not coverable, parties can then still negotiate the appropriate risk allocation.

Sherman: There is no cookie-cutter approach to managing transactional risk. Each acquisition is unique, and the management of transactional risk must take into consideration the goals, facts and circumstances of the transaction, as well as the business and its inherent risks. Whether considering M&A insurance as a tool to managing transactional risk or not, it is important to negotiate and customise the representations and warranties based on the specific risks and circumstances of the business.

Rittberg: Acquirers should work with their insurance brokers to understand M&A insurance providers' process and appetite for risk. They should understand how much experience providers have with consistently and commercially delivering policies for fast-paced transactions and paying claims. Some of the most successful acquirers understand that a collaborative policy underwriting process with a carrier that understands a buyer's due diligence strategy and is familiar with the buyer's advisers can help win deals and lead to better long-term results. Claims payment is as important as deal execution and acquirers should want to know who stands behind their policies, how many times the provider has made multi-million-dollar claims payments, and what is their claims handling philosophy.

Hendry: To avoid unnecessary surprises toward the end of a transaction, at an early stage in the process it is important to understand the scope of protection that an M&A policy can offer and where the buy-side team needs to provide support through the due diligence phase. This should ensure that the cover position can be maximised and any material risks that fall outside the scope of the insurance can be fully assessed. Early engagement with an experienced broker should ensure that the M&A insurance process is well managed from the initial discussions, through underwriter selection and policy negotiations.

Lessman: Managing transactional risks starts with due diligence. Only after completing a comprehensive diligence process will a buyer be in a position to understand the risks that are particular to a given target, versus those that are particular to a given industry. A buyer can protect itself from unknown risks by getting representations and warranties that are backstopped by an escrow, R&W or both. With respect to known risks, the only way to identify them is by conducting an extensive diligence review, and once those risks have been identified, the buyer can decide the best course of action. It can be insulated by obtaining a specific indemnity from the seller, a covenant and closing condition or an adjustment to the purchase price. An escrow or an R&W policy can only protect a buyer so much, and if the buyer has not done the diligence, then it will not be able to protect itself through other avenues.

Kowalski: Utilise M&A insurance products like R&W and tax policies to help mitigate risks on deals. Acquirers' risk tolerances vary. Some will buy more or less insurance than a traditional escrow of 10 percent of deal size and also excess fundamental or tax coverage up to the purchase price based on their risk tolerance. Additionally, in these uncertain economic times, insureds should partner with an insurance carrier with a consistent, proven track record of providing buyers and sellers with sustainable M&A insurance solutions no matter the deal environment. Many policies have multi-year tails with a significant number of claims being reported after a traditional escrow is released, so insureds are really buying a long-term relationship with the carrier.

Read: When approaching a deal, it is helpful when a buyer is clear on its risk appetite for deal risks and on how it will manage these. While W&I insurance can form an integral part of this risk strategy, it is an often-repeated cliché that the product cannot be a 'shortcut'. The most effective risk management strategies come out of the hard work and diligence of the buyer and the deal negotiations. The drafting of sale agreement protections, the diligence efforts and the full engagement of sellers are all key areas to help manage risk. W&I insurance can then provide protection behind all these efforts to manage risks in a deal.

Wakefield: Even the best diligence can fail to uncover every issue in a transaction, which makes R&W a powerful tool. But R&W is not a boilerplate product, and deal parties need to work with advisers who think creatively about how insurance applies to each specific transaction. Where exclusions for 'known' issues arise, they must be very narrowly tailored to avoid inadvertently excluding any other matters. Those very same known risks too often compromise deals. But tax and contingent-risk insurance can help parties navigate an impasse arising from an identified risk that R&W will not cover, by transferring that risk from the parties to the insurance markets.

FW: Looking ahead, how do you expect the process of transactional risk management to evolve? What new strategies and techniques are coming into play?

Rittberg: In the short term, transaction risk management is a bit uncertain due to COVID-19. One impact is a likely rise of distressed deals and continued pressure on buyers to have as complete an understanding of the liabilities they are taking on when they purchase a business. Perhaps we will see greater focus on matching policy terms with the due diligence process and timing of the deal diligence on distressed or bankruptcy-related transactions. More partnership and collaboration on cross-border transactions will continue, along

> "EACH ACQUISITION IS UNIQUE, AND THE MANAGEMENT OF TRANSACTIONAL RISK MUST TAKE INTO CONSIDERATION THE GOALS, FACTS AND CIRCUMSTANCES OF THE TRANSACTION, AS WELL AS THE BUSINESS AND ITS INHERENT RISKS."
>
> MARC B. SHERMAN
> Alvarez & Marsal

with industry specialisation by deal size and sector. Products will be used more frequently for strategic acquirers that have not adopted the products as much as private equity buyers in the past. We expect an increase in the use of tax insurance going forward, as that product continues to gain acceptance, and that interest in tax may even accelerate with the US presidential election coming soon. Finally, we expect claims handling data and procedures will continue to improve and partnerships will strengthen between insurers and insureds.

> MANY POLICIES HAVE MULTI-YEAR TAILS WITH A SIGNIFICANT NUMBER OF CLAIMS BEING REPORTED AFTER A TRADITIONAL ESCROW IS RELEASED, SO INSUREDS ARE REALLY BUYING A LONG-TERM RELATIONSHIP WITH THE CARRIER.
>
> ELLIOT H. KOWALSKI
> AIG

Hendry: The M&A insurance market has made impressive strides over the past few years and now has the depth of experience and underwriting skills to efficiently underwrite most transactions. As the market continues to mature, the level of product and sector specialism is expected to expand. We already have subsectors looking purely at tax risk or title risk, and as technology contributes further to underwriting analysis, we see a time where aspects of transaction risk will be left with insurers to do the majority of the analysis on behalf of the transaction. The impact of COVID-19 has led insurers to look again at how W&I cover can be provided purely via a set of synthetic warranties that only exist in the policy. We consider that while the product is in this early phase there will be a limited set of transactions that will be able to use it. Inevitably, however, the transaction set will broaden through a combination of technology, underwriting experience and competition for market share.

Lessman: Given our current environment, it is anticipated that we will start to see deals involving distressed assets and those coming out of the bankruptcy process utilising R&W coverage. Moreover, we are seeing new contingent products come to market.

Kowalski: Policies are now being placed on deals involving healthcare, minority investments, secondary transactions, public transactions, private investments in public equity, and, given the current recessionary economic environment, distressed and 363 bankruptcy sales. In particular, for sales conducted in a bankruptcy process, insurance can help protect against financial loss when a breach of representation is not cleansed by the 'free and clear' sale order issued by the bankruptcy court. We see this as a logical evolution of the use of the product and could help pave the way for the product being used on other types of corporate transactions outside of pure M&A.

Read: We have noted that M&A insurers are changing their approach to risk assessment and the use of different types of advisers in the underwriting process is growing. With losses concentrating around financial statements in particular, there has been greater focus on financial due diligence and increased consulting of accounting experts. Another change we have noted is the US M&A insurance market's move to spreading larger limits between multiple carriers. This is opposite to the current European strategy of ever larger limits offered and just the one sole carrier used in M&A insurance placements. We understand that this US trend is progressing as clients and brokers look to avoid 'concentration risk' with a single insurer and, in so doing, diluting potential issues in claim disputes.

Wakefield: I would emphasise the growing availability of insurance for known risks. We too often hear, 'if only I'd known that existed when my deal fell apart'. For example, successor liability risk for hot-button litigation in an asset purchase often creates a wide negotiation gap, but even lawsuits involving matters such as wage and hour compliance and grisly personal injury allegations can be transferred to insurance. The same goes for tax issues – just about any tax risk that is not abusive can be insured, even in most foreign jurisdictions. And in the bankruptcy context, R&W and other transactional insurance should expand the scope of potential buyers, as well as drive a higher sales price for sellers in a 363 sale. Given the likely uptick in distressed transactions, this will be a meaningful development in 2020 and going forward.

Sherman: The M&A market over the last decade has bourgeoned, with a proliferation in investment buyers chasing more limited product. This has led to increased deal competition, more deal auctions, shorter diligence periods and increased risk for buyers. These consequences and increased risk lead to buyers' desire for more risk sharing through transaction insurance products, which will likely continue to grow. Also, these consequences are driving buyers to look for additional post-acquisition risk management techniques like tighter working capital requirements and earnouts. Sellers, on the other hand, have greater leverage and are looking to use that leverage to manage their risk through lower working capital targets and greater use of locked box transactions.

Shihab: Synthetic W&I insurance has been spoken about for a while, but this year we have actually seen it implemented – especially in distressed M&A transactions, where having a synthetic warranty proposition has been immensely valuable to clients. We also expect more bespoke and tailored client insurance policy wordings, which will further differentiate parties' bidding propositions. Finally, we anticipate the impact of COVID-19 will likely result in extended warranties being sought, for example access to existing financial or government support, secure material commercial contracts and supply chain, business continuity and insurance, employee and property restructuring liabilities. This may, in turn, result in a rising number of W&I claims. ■

FINANCIER WORLDWIDE corporatefinanceintelligence