

# Breaking the deadlock

In April, HCC Global Financial Products announced it was launching a new line of business focusing on mergers and acquisitions transaction risk insurance. **Deborah McBrearty** discusses the cover available and how it can help both buyers and sellers

**Y**our company is all set to buy or sell. The other party is equally keen. But then you hit a stumbling block. It may be doubt about unspecified risks that could emerge in the future, or a specific issue that is unlikely to produce a liability but just might turn sour.

Negotiations then become tense over price and the kind of financial recourse that the seller is prepared to offer. This is where transaction risk insurance can help to smooth the way, so that both parties can proceed with peace of mind.

## The products Warranty and indemnity insurance

Warranty and indemnity cover (W&I) is effectively the core product of transaction risk insurance. In the USA and some other jurisdictions, the same risk solution often goes under the name of representations and warranties insurance.

W&I essentially guarantees the promises that the seller gives in a sale and purchase agreement. It can apply when there is a sale of shares (ie a share purchase agreement) and also where a business is being sold as a going concern by means of an asset sale. However, it would not normally apply to a public company takeover where warranties are not usually given.

By backing the warranties and certain indemnity promises that are given in the sale and purchase agreement, W&I enables both buyer and seller to gain a greater level of security regarding the information provided to the seller and any indemnity commitments. For example, a buyer will carry out due diligence relating to a potential purchase and will also, when negotiating the purchase contract, require the seller to provide information on relevant matters.

These can cover a wide area. It may include statements about the

company's accounts, its employees, the way the stocks are held, the intellectual and real property involved, any material contracts and so on.

Understandably, the buyer will want to know if there are any potential problems, for example relating to employee disputes, validity of licences, compliance with accounting regulations and so forth. By drawing out from the seller this kind of information before they actually buy the company, the buyer can factor the disclosures into the price negotiations, so that they do not develop into a claim between the parties after the transaction is completed.

Problems can arise, however, where the seller gives a warranty in all good

faith because they are actually unaware that a potential problem exists. For example, they might warrant that there are no employee claims without realising that, lurking at the bottom of some filing tray, there is a complaint relating to an employee that could produce a claim in the future. After the company is sold, this claim might materialise and the subsequent loss might mean that the value of the company is less than the buyer believed it to be at the time of purchase.

In such a case, the buyer would want to claim against the seller for the amount of the diminution in the value of the business on the basis of breach of warranty. Essentially, facts

and circumstances that existed before the sale were not disclosed and, as a result, the company is worth less. To guard against this scenario, the buyer might look for the seller to agree to pay back up to 100% of the purchase price to reflect the amount in value that the buyer has lost.

Understandably, sellers are reluctant to give this kind of commitment. The business owner(s) may be looking to realise the benefit of the hard work and money they have invested in building up the company to fund a worry-free retirement or other activities. Or, if the selling company is sizeable, it may be seeking to sell off a non-core division so that it can refocus and



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put money back into its core business – a particularly common situation at the current time, when many companies are looking to realise capital that they can divert to more profitable areas.

Similarly, where there are private equity or institutional investors, these may have made their investment in the company out of a certain fund and are looking to sell off this business so that they can return the money to investors in that fund and close off the sale without any potential future liabilities relating to it.

The situation can sometimes be alleviated by a reduction of the sales price or by part of the sales price being put into an escrow account for an agreed period. However, these solutions are not usually very attractive for sellers and sometimes cause administrative difficulties for buyers as well.

W&I basically bridges the gap between what the buyer wants and what the seller is willing to give, enabling them to transfer the risk of a claim to the insurance market. It can be bought by either the seller or the buyer. For the seller, it has the benefit of limiting the level of liability they

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might have under the sale and purchase agreement, removing any encumbrance on the funds from the sale.

Alternatively, the buyer can purchase as much recourse as they need to be comfortable to do the transaction, and possibly also choose a longer period for which they want recourse to apply than the seller might otherwise be prepared to give. For example, a seller might give warranties and be prepared to leave some money 'on the table' for a year in case a problem arises, but be reluctant to commit to a longer period. But a year might not be enough.

For example, in the UK the tax authorities have up to six years to

challenge any particular year of tax return, so the buyers might not feel comfortable with only being able to claim against the seller for the first year.

W&I only provides cover for unspecified and unknown breaches of warranties. However, there may be some specific areas of doubt that arise during negotiations – which is where other types of cover can help.

### Tax indemnity

Tax laws are extremely complex. It is not always clear as to the type of accounting treatment – and the tax implications – applied to certain activities, reorganisations or corporate structures. Therefore, while the sellers of a company may have followed their accountants' advice, allocated certain treatment to activities in their accounts and duly filed their tax returns, it is possible that there might be another interpretation to the rules or the way they are applied to that particular aspect of the business. Even the seller's advisers themselves might warn there is a slight risk in following their advice in that the revenue authorities might see it differently and could ask for additional tax.

Financial due diligence would make potential buyers aware of this issue. If there is a possible question mark over future tax liability, the parties to the deal need to agree who will bear that risk. Tax indemnity is designed to give insurance underwritten protection against that risk, once again smoothing the path for the deal to go ahead.

### Contingent risk transfer cover

Contingent risk transfer insurance covers the situation where there is a specific known issue that the seller believes is unlikely to materialise into a claim – but the buyer isn't so sure.

For example, the buyer might be looking to purchase a mortgage broking business where there has been a complaint from a consumer action group that secret commissions have been taken. The seller may be certain that this is unfounded, but the buyer can envisage a potentially serious problem if the action group decides to bring a case. Contingent risk transfer insurance provides protection in this type of scenario.

### What insurers need to know

In order to assess a transaction risk, basically we need to have all the information that is in the buyer's and seller's possession. For example, if we were insuring a buyer, we would

## HCC experience

When HCC Insurance Holdings Inc (HCC) acquired MAG Global Financial Products in 2002, MAG's name changed to HCC Global Financial Products. Although MAG had offered M&A transaction risk products, HCC put this line of business on hold, preferring that this subsidiary focus on the core business of directors' and officers' liability (D&O), professional indemnity insurance (PI) and other financial lines.

HCC Global, now backed by the HCC Group's AA rating, further developed its international focus on financial lines. It never relinquished its in-house expertise in M&A transaction risk, however, believing that this was a good type of product to be able to offer its clients.

With the recession came a downturn in M&A activity, but the financial crisis also highlighted the fact that, when M&A started to take off again, investors and buyers would probably be more cautious about their transactions and more aware of the risk issues. They also welcome reliable solutions, which HCC Global is well positioned to offer, enabling them to get deals done rather than negotiations ending in deadlock with neither party able to agree a compromise. In view of this, it seemed to us to be an ideal time to re-enter this market.

review their due diligence reports. In the case of a specific tax policy, we would expect to see the advice from both sides' advisers regarding the tax issue and would also seek our own independent verification of these opinions.

Other factors include the type of business and the jurisdictions concerned. We will consider all non-US jurisdictions and are focusing particularly on continental Europe as well as the UK. Over 23 nationalities speaking over 31 languages are represented in our Barcelona office, which means that we can deal with transactions where documentation is not in English.

Getting to know a business thoroughly can take time but we are conscious of the importance of meeting the transaction timetable and will never unduly delay this.

## Conclusion

This type of insurance product is not sector-specific. Every deal is different and there are no restrictions on the type of business to which transaction risk insurance can apply. Currently, we are seeing some resurgence of M&A in the natural energy sector, with bigger players looking to acquire smaller independent businesses that have established a foothold in that market. There is also some consolidation within the IT sector, with acquirers bringing together complementary technologies to provide a fuller service.

The prime value of transaction risk insurance is deal facilitation. It is a means of smoothing the path of transactions and sometimes actually removing what would otherwise be deal breakers because buyers and sellers cannot agree on how risk should be allocated.

It also helps sellers to unlock the full value of their company. Often they have good 'gut instinct' of the worth of their company, which the buyer will not share.

If sellers can back up their promises with a strong, highly rated insurance product, quite simply buyers will often be prepared to pay more. And both parties can proceed with confidence and security to finalise a deal that will benefit both – which is what M&A should be about. ■



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