TRANSACT

Transactions
Tax & Specialty

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ROUNDTABLE August 2021

MANAGING TRANSACTIONAL RISK

Risk is a virtual inevitability in all transactions. To manage risk scenarios as and when they occur, transaction parties need to ensure that key areas, such as due diligence and transaction insurance, are addressed, so that the deal process remains inherently robust and comprehensive. With deals becoming more complex and the COVID-19 pandemic providing added disruption, going forward, dealmakers must ensure that adequate attention is paid to identifying, assessing and managing risk. ■

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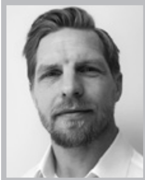

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FW: Are acquirers in general paying enough attention to identifying and assessing risks during the transaction process? Are they falling short on any particular aspects in today's market?

Shirley: While the precise approach to the transaction will be subjective to the acquirer, our experience is that it is in all parties' interests to see the transaction as a success given the resources committed, underlying expectations and drivers to the acquisition. As such, we generally note that parties are aligned in ensuring key areas are addressed and therefore the due diligence process continues to, for the most part, remain robust and comprehensive. In more competitive sectors, one of the key concerns is understanding the valuation and approach to securing a target. Understanding the drivers, be it market share, synergies or growth potential, is a key element as the perception of overpaying for a deal always remains a concern from an underwriter's perspective.

Sherman: Risks are inherent in transactions, and problems no doubt will, at times, be discovered. They will never totally be eliminated. But are the number of problems in contemporary transactions arising at an unexpected or reasonable level? Recent data shows us that representations & warranties (R&W) and warranties and indemnities (W&I) claims frequency is between 15 and 20 percent depending on deal size and year. That suggests that more attention could be paid to identifying and assessing certain risks. There are some explanations. The M&A market continues to be hyper-competitive and diligence periods continue to shrink, at the same time deals are becoming more complex. These conditions create a heightened risk environment while simultaneously providing less time and opportunity for deep or broad diligence.

Lessman: Acquirers that have used the transaction insurance product before have typically done a thorough analysis consisting of identification and assessment of risk during the transaction process. Organisations that have taken advantage of the product previously understand the types of issues that insurers are watching for and can anticipate the questions that an insurer may have based on due diligence findings. Acquirers have not been falling short on any aspects in the market today. Acquirers have been communicating earlier in the process regarding due diligence, including the scope and the parameters of diligence being completed. This helps to smooth the underwriting process and improves the deal outcome.

Reynolds: In general, M&A deals seem to be occurring on shorter and shorter timelines. Deals also seem to be subject to more significant last-minute revisions. Such haste can lead to greater risk for buyers and insurers, as there may not be enough time for thorough due diligence related to some of the issues that arise. In today's hot M&A market, buyers seem eager to acquire all kinds of companies, including targets with substandard equipment or products. R&W insurance is not intended to compensate buyers for businesses that do not perform well following the acquisition, unless that poor performance is linked to factors misrepresented by the sellers.

Kearns: Overall, we believe acquirers are paying adequate attention to identifying and assessing risks during the transaction process. The challenges over the past year with the pandemic have brought renewed scrutiny around the nature of many target businesses, particularly in areas such as hospitality, retail, travel and leisure, as well as supply chains, customers, material contracts, geographical reach of the target's business operations, health and safety measures, business continuity and financial and valuation. Many of these pandemic-related focuses are likely to continue to be scrutinised for the foreseeable future, particularly areas such as business continuity planning, geographical footprint of a business and business valuation.

Shihab: From an insurer perspective, a recent trend is that more risks are being brought to our attention, and a lot earlier in M&A processes. Acquirers and their advisers have become very sophisticated users of transaction insurance products. And as a result, they are increasingly asking what can be insured, from both an unidentified and identified risk perspective. W&I insurance has also led to more emphasis on the due diligence process as opposed to seller disclosure. While the reports might be getting more concise in length, their scopes seem to have generally widened, given the less meaningful disclosure process. Our experience is that the current diligence process leads to more issues being discovered earlier in the process.

O'Keefe: The strong M&A market presents challenges for acquirers in completing fulsome due diligence because deals are happening at such a fast clip. Two areas deserve more attention. First, wage and hour lawsuits continue to surge. Given that there is often no other insurance to cover these claims, and the statutory look-back period can go back as far as two to four years, R&W insurers are increasingly the first line of defence. Buyers should expect to perform thorough due diligence on wage and hour, specifically around exempt and non-exempt employee classification, the use of independent contractors, and off-the-clock work and meal and rest mandates for non-exempt employees. With the prospect of liquidated damages, statutory penalties, and attorney's fees, liability can quickly add up. More recently, we have also seen acquirers struggle with completing adequate cyber and IT due diligence. The rash of ransomware attacks with significant payouts and the hardening of the cyber insurance market has made buy-side due diligence more important than ever.

Rittberg: Buyers want to deliver strong returns to their investors, protect their constituents and be properly motivated to diligence the target companies and identify and assess the risks related to acquisitions. They do not want to acquire an unexpected liability or find out that the target is not what they thought it was, so they are engaging outside advisers and internal specialists to avoid surprises. We do not see any glaring holes in the deal process, but time frames to complete diligence have

shortened and it is as competitive as ever to win deals in today's market. Transactional insurance providers can be valuable partners in navigating this fast-paced market and helping ensure proper diligence and disclosure happens.

FW: What are the key areas that need to be considered as part of a due diligence process? To what extent is the scope of due diligence widening to incorporate 'non-traditional' areas of assessment?

Sherman: In addition to the conventional areas of due diligence, the necessity for more specialised diligence will depend on the particular facts and risks of the specific transaction. When there are additional risks, they require a widening of the focus and diligence process. Some of the areas that may present non-traditional risks and tend to demand deeper and non-traditional assessments include carve-out, healthcare and software – particularly software-as-a-service – acquisitions.

Lessman: Due diligence is the most critical component of the transaction, which covers a considerable number of areas. From an insurance perspective, in almost every deal, general corporate matters including capitalisation and authority, financial and accounting affairs, tax matters and employment and employee benefits need to be considered when setting forth diligence parameters. In addition, depending on the industry sector of the target company, other areas such as regulatory, cyber security and privacy, environmental or product liability may also be considered as part of the due diligence process.

Reynolds: One key area for R&W insurance claims has been lost customers. It is important for buyers to carefully assess the strength of the seller's customer relationships and how those might be affected by the acquisition. R&W insurance is not intended to cover the business risk of losing customers. It covers a seller's representation that it does not have actual knowledge that certain customers intend to cease doing business with the target company, or significantly reduce the amounts of their purchases. Rapidly evolving risks such as cyber are becoming an increasingly important part of the diligence process.

Kearns: Due diligence is essential in every M&A transaction. It is this process that allows a buyer to confirm the pertinent information a seller presents about the target business and allows the buyer to gain a thorough understanding of the target's obligations as they relate to the operations of the business, such as finances, debt, key customer and supplier agreements, leaseholds, lawsuits, taxes and employment contracts. From an R&W insurance underwriting perspective, the quality of the buyer's diligence is ultimately going to determine the breadth of coverage provided under the R&W policy. An R&W policy is not intended to cover matters that could have been known if a proper level of industry accepted diligence were performed. As such, where a buyer elects not to perform such diligence, this should result in policy limitations or exclusions as they relate to R&W for which the acceptable diligence was not conducted.

Shihab: Traditional insurance problem areas, as well as environment and cyber, now appear to be the norm of due diligence scoping exercises. Interestingly, we are seeing an overlap between advisers covering off these topics. For instance, it is not unusual to see both the insurance due diligence report and the legal due diligence report both reviewing insurance. The commercial diligence might now consider the cyber security situation, along with a separate IT and cyber due diligence. This year also saw Lloyd's silent cyber rules come into effect. These rules require insurers to articulate whether they are affirmatively covering or excluding cyber in the W&I policy. This has forced insurers to consider cyber in their underwriting much more than previously was the case. These new rules also reflect how much cyber security is relevant to nearly all business these days. Accordingly, we increasingly see cyber security due diligence for companies that you would not at first consider to be high risk – which, in the context of the new Lloyd's rules, is extremely helpful. Finally, it has been heartening to witness a marked increase in environmental, social and governance (ESG) due diligence reports now being prepared.

O'Keefe: We expect that due diligence will be completed in all key legal and operational aspects of the business. At a bare minimum, this involves corporate documentation, labour and employment, employee benefits, real estate and intellectual property (IP), IT and data security. Increasingly, the scope of due

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> SAMMY SHIHAB
> Transact Risk Partners LLP

diligence has widened as companies from a broad range of industries become targets. We have also seen an uptick in deals involving US government contractors and those where the company's products are primarily sold in non-US markets, which can trigger concerns about export and import laws, bribery and foreign corrupt practices. Full due diligence is always necessary when the target company touches these areas.

Rittberg: Diligence should include evaluation of the financial, operational, and customer and supplier aspects of the target business. Comprehensive legal diligence may include corporate, tax, employee benefits, environmental, intellectual property and regulatory questions. For transactions with international components, trade, corruption and bribery due diligence may be part of the process. International deals may require local legal or regulatory expertise. Coronavirus (COVID-19) has added a new set of questions to the diligence process, including how businesses operate using remote access technology, how personnel are protected and what constitutes reasonable in-person due diligence in the age of Zoom. The newer and perhaps 'non-traditional' areas now include more work on a target's systems and IT infrastructure and capabilities to operate safely with adequate cyber security.

Shirley: On a core level, we need to see appropriately scoped legal, tax and financial due diligence which is tailored toward the business. From there, it becomes more sector specific. For instance, in respect of manufacturing operations, what level of environmental, health and safety review has been undertaken? For a tech business, is there specific IT due diligence or a review of the use of open source software? One of the most important elements is seeing the quality of earnings and understanding the adjustments to managements' assertions and how that is reflected through the valuation. As emerging cyber threats continue to evolve, we are also seeing specific cyber reports and commentary on insurance arrangements to understand how these may respond to a cyber incident.

> IF YOU ARE SEEKING R&W INSURANCE AS PART OF THE TRANSACTION, THE INSURER LIKES TO SEE THAT THERE IS STILL AN ACTUAL NEGOTIATION OF THE R&W PACKAGE, EVEN WITH THE INSURANCE COVERAGE.
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> BRYAN M. O'KEEFE
> Seyfarth Shaw LLP

FW: What key advice would you offer to buyers and sellers when it comes to negotiating representations and warranties?

Reynolds: Representations and warranties set out the key facts about the target business. Up to the policy limit, R&W insurance covers much of the risk associated with breaches of the representations made. However, a bad deal is still a bad deal. A seller is uniquely positioned to understand its business, and the due diligence process enables the buyer to identify risks associated with the target company. If the buyer and seller do not negotiate a fulsome set of R&W, it puts both the insurer and the buyer at risk that the business does not meet expectations. Since most buyers choose to insure only 10 percent of the purchase price, the buyer is often exposed for the value of the deal in excess of the policy limit.

Kearns: Buyers and sellers should ensure they have the right legal, financial and insurance advisers, and that includes choosing the right insurer. Engaging in a purchase and sale of a business is a crucial turning point in the life cycle of a business for both the buyer and the seller, and the right advisers can often make the difference regarding whether a transaction goes smoothly. With the use of R&W insurance now a regular and integral part of the purchase offering, to the extent the parties, particularly the buyer, can contemplate how certain R&W may be perceived by a prospective insurer, this will likely have a positive impact on the breadth of the coverage provided for such R&W under the policy.

O'Keefe: If you are seeking R&W insurance as part of the transaction, the insurer likes to see that there is still an actual negotiation of the R&W package, even with the insurance coverage. Unfortunately, this is not always the case and given the rise in claims, insurers are increasingly 'reading out' off-market reps at the non-binding indication letter (NBIL) stage or even after the underwriting call. Some of these read-outs are extensive but are necessary given the use of reps that a seller would never agree to absent insurance. Insurers are appreciative when the seller takes an active role in the negotiation of the deal.

Shihab: It is vital to include the insurer and broker in the process. Both brokers and insurers are now central parties to the R&W negotiation process. By sense-checking a warranty scope with the insurer, the insurer can already provide diligence scope expectations and difficult cover areas or areas that the policy could enhance. Parties can also use the insurer's position

as a balanced market position barometer. For an insurance policy to work best and align with the R&W, the R&W given must represent a balanced market standard – too buyer-friendly, and the diligence requirements can be too onerous. There may be move deviation from the warranty coverage position in the purchase agreement to the underlying insurance policy. And a too seller-friendly position means the buyer is likely not extracting enough value out of the policy.

Shirley: There may be a temptation to provide an extensive level of warranty protection that does not necessarily focus on the key areas. It is worth considering the context of the target and how the due diligence is going to relate. For instance, does a product liability warranty provide any comfort for an advisory business? We advise that the warranties are tailored to the key risk areas and that the due diligence corresponds to these to align insurance cover as far as possible. The seller may also want to consider the nature of the warranties as they may be asked to assume the risk where the insurer cannot get sufficient comfort. This is where the insurance advisers come in, as engaging with them at an early stage will help to ensure an appropriate and insurable warranty package is being delivered.

Rittberg: As transactional insurance is now a standard part of the M&A process, buyers and sellers should ensure that the representations and warranties do not change materially with insurance in the picture. Underwriters consistently ask whether it is possible for sellers to make any specific representation and whether it is a representation that a buyer could diligence and verify. To the extent that we think a representation could not be made by a seller, or the buyer could not diligence or verify that representation, we may modify the language in the representation or exclude that representation from coverage. Transactional insurance works best as a collaboration between insurers and insured, and to navigate today's competitive market quickly and efficiently, buyers and sellers need to treat insurers as partners on their deals.

Lessman: Parties should understand that not all R&W of the seller are covered. There are standard exclusions to coverage, such as covenant breaches, forward-looking statements, or purchase price adjustments. Make sure you have a clear understanding of what is included and what is excluded in the insurance policy you are purchasing. If a representation or warranty is not covered, the parties will then have to determine who is liable for the gaps in coverage. We would also recommend that the buyers and sellers choose a carrier that is transparent at every step and makes the entire process as efficient as possible, while keeping the deal on schedule.

> PARTIES SHOULD UNDERSTAND THAT NOT ALL R&W OF THE SELLER ARE COVERED. THERE ARE STANDARD EXCLUSIONS TO COVERAGE, SUCH AS COVENANT BREACHES, FORWARD-LOOKING STATEMENTS, OR PURCHASE PRICE ADJUSTMENTS.
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> TORIA LESSMAN
> QBE North America

FW: What are the fundamental benefits of purchasing representations and warranties (R&W), or warranties and indemnities (W&I) insurance, for customers? How does it affect the timeline of the sale?

O'Keefe: R&W and W&I play a fundamental role getting the deal done. The beauty of the product is that it benefits both buyers and sellers. The seller has increased capital liquidity and can walk away from the deal leaving behind a minimal escrow account, or sometimes, none at all. The buyer has a reliable partner on post-closing disputes and can file a claim on the policy, just like it would any other insurance. We know from the available data that claims are paid, sometimes quite substantial claims. The product effectively resolves one of the most vexing aspects of a transaction. Deals with R&W or W&I move much faster. Without insurance, a substantial amount of the negotiation between the parties involves protracted debates over baskets, caps, deductibles and so on. Instead, the parties can work with an experienced broker, have quotes in hand, select the insurer and go through an underwriting practice with a bound policy – a process that can take a few weeks, even less if the deal requires it.

Rittberg: Transactional insurance frees up capital, avoids disputes and allows for a more efficient deal process. W&I insurance has been accepted as an attractive alternative to seller indemnity and sometimes offers broader coverage than sellers have provided in the past. Over the past decade, transactional insurance 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. Even more importantly, this insurance now has a proven track record of paying hundreds and hundreds of millions of dollars of

claims. With more insurance brokers and law firms negotiating template policies with M&A insurance providers, policies can be obtained more quickly than ever. Policies can be bound in a few days rather than weeks.

Lessman: R&W insurance has countless benefits for both buyers and sellers. For example, it allows a seller to walk away from the deal with no indemnity obligations, escrow, or holdback. In addition, the coverage allows sellers to have cleaner exits and fewer liabilities. With respect to the buyer, the insurance can make a buyer's bid more attractive. The coverage can also increase the amount of protection available for the buyer. For both parties, the insurance simplifies and speeds up the negotiation of the agreement. R&W insurance should not have an impact on the timeline of the sale. The insurance process moves in parallel with the deal and should not be an impediment.

Shirley: One of the more recent trends has been the compressed timetables and looking to have an insurance policy in place pre-exclusivity in competitive auction processes. This is an incredibly useful tool for bidders to be able to deliver their bid package with a W&I policy ready to go, as it means the deal can be wrapped up in a tight time frame, giving the sell-side confidence in the bid and highlighting the level of work that has been undertaken by the buy-side to try and secure the target.

Shihab: Contrary to the case a few years ago, having W&I insurance should speed up the transaction process. Taking an auction process as an example, a seller can already set up the insurance process well in advance of negotiating with potential bidders. This is done by including an auction policy in the data room and a document that outlines the insurer's scope expectations to get full policy cover. Or to take it a step further, to provide a policy that includes affirmative cover based on vendor diligence. By structuring the process upfront, potential purchasers are likely to negotiate less on the transaction documentation and warranties. They also have a clearer understanding of the insurer risks issues, which diligence can then tailor.

Kearns: The foremost fundamental benefit of R&W is that it helps the parties close a deal. R&W insurance can reduce risk to the seller, where the seller transfers liability for unknown or unanticipated breaches of its R&W to the insurer, thereby reducing or eliminating the need to set aside an escrow or post a reserve or collateral for potential breaches of R&W. Similarly, the R&W insurance allows a buyer to benefit by reducing its counterparty credit risk on the seller by transferring the risk to the insurer, providing indemnity for the seller's unanticipated breaches. Further, with the prevalence of R&W insurance, a buyer's bid is likely to be deficient without including R&W insurance, particularly where R&W insurance can alleviate the need for the seller to post a substantial escrow for up to 18 months after the transaction closes. Lastly, R&W insurance gives the buyer the added benefit of safeguarding business relationships where the sellers will continue to be involved in the business post-sale, as the insurance protects these vital business relationships and allows the parties to focus on successfully operating the business.

Reynolds: Since a seller is very familiar with its business and the buyer is not, the buyer relies heavily on the R&W made by the seller. The due diligence process goes a long way toward confirming those representations. However, there are residual risks that last long after an acquisition. These are contingent liabilities that must be taken into consideration, for example when a private equity fund distributes funds to stakeholders. To cover these potential liabilities, acquisition agreements often require sellers to put money into escrow. R&W insurance can reduce the amount held in escrow, freeing up cash for investment. It can also expedite transactions by reducing prickly negotiations over immaterial risks.

"R&W INSURANCE CAN REDUCE THE AMOUNT HELD IN ESCROW, FREEING UP CASH FOR INVESTMENT. IT CAN ALSO EXPEDITE TRANSACTIONS BY REDUCING PRICKLY NEGOTIATIONS OVER IMMATERIAL RISKS."

ROY REYNOLDS
Great American Mergers & Acquisitions Liability Division

Sherman: R&W and W&I promote faster transactions and often give buyers leeway to negotiate other benefits in exchange for reducing seller escrows and indemnities because of the insurance. In addition, if a claim is necessary, the seller has the benefit of resolving the issues with an insurer that approaches claim resolution in a logical and professional manner, rather than the often emotional approach and mindset of sellers.

FW: In addition to R&W or W&I insurance, to what extent are you seeing rising demand for coverage in specific areas, such as tax risks and contingent risks?

Lessman: We have been seeing an increase in submissions with respect to both tax

and contingent risks, particularly judgment preservation insurance submissions. This expansion is partially due to the growing number of tax and contingent brokers in the market. Another reason is the rising overall awareness of the product. With respect to the uptick in tax submissions, this is also related to president Biden's proposed tax changes, in particular the effective date of the capital gains tax rate. That being said, the market is generally not currently insuring that type of risk – the change in tax law – because this is typically excluded from coverage.

Shirley: There has been an increase in broker activity, which has naturally led to a greater awareness of potential solutions. One of the issues we often have with contingent risks is getting sufficient insight to fully explore the risk. This often requires some form of insurer advice, which parties may be reluctant to engage with unless they have some indication that there may be an insurance solution. As such, on the contingent front there are often several conversations taking place, but these do not always lead to either insurable risks or being taken up once fully explored. There are some very good risks out there, and the key thing for us is understanding the driver for insurance.

Shihab: We have seen significant increases for both tax and contingent risk insurance. Specialist brokers for both tax and contingent risks continue to increase. And so too does the market awareness. Using tax insurance as an example, we now get daily requests from brokers located in the UK, Netherlands, France, Spain and so on. When you think about the many instances each day that a taxpayer must make decisions on an uncertain or unclear area of tax, the room for growth in the tax insurance market is hard to get your head around. As more taxpayers use and become familiar with tax insurance, the product can disrupt the tax landscape. Risk transfer and certainty can become mainstream in an area of law that has traditionally been uncertain and high risk.

Kearns: We continue to see demand for tax and contingent liability insurance, particularly with the continued increase in M&A activity. These transactional insurance offerings can be presented as standalone risk opportunities but can often be an effective means of risk transfer when taken out of an M&A deal. Tax insurance is often used to insure certain tax positions taken by the seller in a particular deal when a buyer realises it may be liable for a tax exposure as part of an acquisition. The benefit of the insurance is that the parties involved can reduce or eliminate exposure to identified tax risk by procuring separate policies, which helps facilitate the deal closing and procurement of R&W insurance for the deal. The same can be said for contingent liability insurance. Like tax, contingent liability insurance is another form of risk transfer in M&A, particularly in distressed transactions. Also, with respect to contingent liability we have seen several insurers and advisers devote dedicated resources to this space, which has demonstrated the ability to effectively underwrite to these exposures, presenting contingent liability as a premium growth opportunity in the same way tax insurance was five or so years ago.

Rittberg: We expect continued increase in the use of tax insurance going forward as that product continues to gain acceptance, and interest in tax insurance may even accelerate with potential changes to tax legislation on the horizon. We also expect an increase in contingent risks like litigation-related insurance to increase in 2021 and beyond.

Reynolds: R&W insurance covers matters that are not known at the time of the acquisition. However, due diligence and risk assessment often uncover known risks that are excluded from the representations policy. If a tax risk has been identified, it may be excluded and covered under a separate tax policy. Typical matters covered by tax insurance include qualification of real estate investment trusts and S Corporations, as well as the tax treatment of various transactions. In addition to its uses in the transactional context, tax insurance may be used for general balance sheet protection or to backstop the qualification for various types of tax credits. Awareness of tax indemnity insurance is lagging that for R&W. However, more and more brokers are entering the space. I would expect more rapid growth in tax insurance over the next several years.

Sherman: Companies have expressed interest for a while in transferring risk on many different types of transactional tax exposures. Recently, insurers have

> WITH ITS BROAD COVERAGE AND EFFICIENT PROCESS, WE EXPECT THAT TRANSACTIONAL INSURANCE WILL CONTINUE TO PLAY AN IMPORTANT ROLE PROTECTING M&A DEALS AND PAYING CLAIMS.
>
> JAY RITTBERG
> Euclid Transactional, LLC

been very creative in developing new products, including several products to deal with various types of tax risks that were previously uninsurable. Also, in the R&W and W&I arena, insurers have been innovative to develop approaches to covering larger transactions, which are happening with increased frequency, by including excess carriers to provide increased total policy limits to support larger transactions.

> THE CURRENT M&A INSURANCE MARKET IS DYNAMIC, FROM AN OPPORTUNITY STANDPOINT, WITH ANY REMNANTS OF THE DROP OFF FROM THE EFFECTS OF THE PANDEMIC ALL BUT GONE.
>
> DENNIS KEARNS
> DUAL Commercial LLC

O'Keefe: We have seen an uptick in 2021 in interest in both tax and contingent risk insurance. Many attorneys and business professionals are not aware of the benefits that these offerings can provide, especially on a standalone basis divorced from a deal. We have also seen leading underwriters expand their ranks and hire underwriters with a specific focus on tax or contingent risk. This type of strategic planning shows that the top insurers view these areas as poised for growth. Additionally, we have seen a rise in the first half of 2021 in secondaries transactions, with continuation funds. With the strong returns of the last several years, many investors are looking for ways to largely retain the current fund dynamics, even though the life cycle of the fund may be ending. R&W can provide an important backstop in these transactions. The risks to R&W insurers are also relatively low, especially if the policy is placed with a reputable private equity firm.

FW: How would you describe the current M&A insurance market? Could you outline some of the trends you are seeing with regard to policies, coverage, terms, pricing, and so on?

Rittberg: After a period where M&A insurance volume was down nearly 70 percent during the early months of the COVID-19 pandemic, we saw a return to record high levels in late Q3 2020 which has continued into 2021. With its broad coverage and efficient process, we expect that transactional insurance will continue to play an important role protecting M&A deals and paying claims. Now, with thousands of claims to learn from, our industry must continue to evaluate our underwriting process and utilise data as we grow.

Shihab: The M&A insurance market appears to have hit a point of maturity. Since the onset of the COVID-19 pandemic, there have been few new insurers entering this space, meaning existing or incumbent insurers have had more time to focus on their preferred markets. Over the last year, the localisation of policies and coverage for many established insurers has increased. A one-size-fits-all approach to underwriting is no longer suitable. Separately, as claims increase in the market, which given most policies have a seven-year term is inevitable, pricing is rising. As more claims get paid, we believe insureds will see the value and understand that a price increase is unavoidable.

Kearns: The current M&A insurance market is dynamic, from an opportunity standpoint, with any remnants of the drop off from the effects of the pandemic all but gone. The levels we are seeing in terms of submission flow are close to rivalling what we saw in the fourth quarter of 2020. We continue to see a good mix of deals in the small to middle market space, that were a staple in this period last year, coupled with a significant number of large market opportunities, as the challenges that may have been posed by the pandemic continue to subside. Pricing continues to be favourable for R&W insurers, as the benefits of the 2020 rebound and increased demand for capacity and claims experience have all contributed to rate increases in the space.

Shirley: Some traditional areas of reservation are now becoming more considered, which reflects the approach to due diligence. For instance, given the prevalence of technology-related targets, it has been great to see an increase in dedicated IT and cyber due diligence which provides a level of insight that would not always have been available. There are increasingly compressed timetables being worked to on competitive M&A processes, and this is where the ability of an insurer and its perceived execution risk becomes the key concern.

Reynolds: The M&A insurance market is booming, not only because the number of transactions is high but also because a greater percentage of such deals are employing transactional risk insurance. Coverage is now available for transactions that would not have been insurable in the past. The market has expanded from exclusively middle market transactions to cover deals with economic values from less than $50m up to multibillion dollar deals. Industries, such as healthcare, that were

shunned in the past can now find coverage with specialised carriers. Coverage is also expanding, driven by lawyers that specialise in transactional risk insurance to facilitate transactions. Pricing for primary R&W insurance is increasing, reflecting both a shortage of underwriting bandwidth and increased frequency and size of claims across the industry.

Sherman: The M&A insurance market is very robust. Seventy-five to 85 percent of private equity transactions are now insured and nearly 60 percent of strategic acquisitions. At the same time, the market is young, leaving room for terms and pricing to mature as insureds and insurers adapt to changes in M&A and the economics of risk transfer. Very importantly, we know from recent claims history that R&W and W&I pay claims – more than several hundred million dollars in a relatively short period.

O'Keefe: The market is red-hot right now. This is a remarkable achievement and shows the resilience of transactional risk insurance, even when facing significant headwinds. It will take us time to appreciate what a feat has been accomplished. Right now we are seeing premiums hover around the 3 to 4 percent mark, owing to high demand and constricted supply. Most policies continue to provide coverage for 10 percent of the enterprise value in the transaction. Towers of insurance to cover deals with higher enterprise values are common.

Lessman: The current M&A market is thriving and continues to experience record growth without exception. Deal flow remains strong, and we have been seeing a consistent flow, with a record number of submissions each month. During the fourth quarter of 2020, the R&W insurance market experienced a rate increase across the board. This trend continued into 2021 and rates have remained strong.

FW: What advice would you offer to M&A parties on choosing the right insurance provider? How important are claims experience and payouts, for example?

Shihab: Our first advice would be to choose a good broker. There are so many variables to finding the right insurance provider. This can be the person's skill underwriting the deal, the underlying strength of insurance, current workload, claims experience and so on. Now that it is a mature product, increased claims are inevitable – and should be an essential factor in choosing an insurer. Brokers should be able to speak to the claims experience of the relevant insurer. Given the materiality and complexity of some claims, it is rare that the payment of claims is a 'rubber stamping' process. However, we would like to think that claiming through an insurer is significantly easier than the existing alternative of claiming directly against a seller. When choosing an insurer, there are two factors we consider particularly important. First, does the broker have claims experience with that insurer? And second, how involved are the underwriters in the claim? Generally, it is preferable that the underwriters are involved so as not to have someone with no background assessing the claim.

Kearns: In the M&A space, an underwriter with experience makes all the difference in a party's experience with R&W insurance. That experience carries through to each component of an engagement from submission, to quote, to underwriting and, if necessary, to claims handling. The key factor in deciding on the best choice of underwriter is service. 'Service' means everything. Parties have a number of choices in selecting an R&W insurer; whether they have made the right choice will depend on that service experience. If insurers are doing their jobs correctly, the insurance should be a seamless addition to the deal participants, as if they are a part of the deal team. That successful engagement begins with timely responses and a commitment to operating in deal time with the parties to the transaction. With ever increasing use of R&W insurance in transactions, the insurance has become a deal facilitator, requiring that the procurement of the insurance remains a deal facilitator and never a deal detractor. Claims handling and payment is the ultimate testament to the utility of the product.

> IT IS IMPORTANT TO LOOK AT THE STRENGTH AND DEPTH AN INSURER HAS, BOTH IN TERMS OF THE UNDERWRITING TEAM'S EXPERIENCE AND ABILITY TO MEET THE TIMETABLES, BUT ALSO WHO IS STANDING BEHIND THE INSURANCE.
>
> SAM SHIRLEY
> Aviva

Shirley: It is important to look at the strength and depth an insurer has, both in terms of the underwriting team's experience and ability to meet the timetables, but also who is standing behind the insurance. This is a long-tail product, and we find increasingly that certainty in claims is critical, as the insured wants to understand who will be dealing with claims, their

experience and that the insurer is going to be there for the long haul.

Reynolds: As the M&A insurance business matures, we are seeing a flight to quality. Some of the biggest underwriters in the M&A space are still managing general agents (MGAs). An MGA relies on the backing of its insurers and may combine the capacity of multiple insurers on a single policy. If the MGA or one or more of the insurers withdraw from the business, this could make it difficult to collect on claims. This problem is particularly acute because R&W policies are long-term policies, generally with six-year policy terms. There are advantages to placing policies directly with a name brand insurer. An insurer that underwrites these policies directly is more likely to remain committed to this business over the long term and has a broader claims-paying reputation to protect.

> THE M&A INSURANCE MARKET IS VERY ROBUST. SEVENTY-FIVE TO 85 PERCENT OF PRIVATE EQUITY TRANSACTIONS ARE NOW INSURED AND NEARLY 60 PERCENT OF STRATEGIC ACQUISITIONS.
>
> MARC SHERMAN
> Alvarez & Marsal

Sherman: The choice of the 'right' provider should favour providers that understand the target's industry, have an underwriting process that is compatible with the buyer and have claims experience. It is also important that the provider have a claims approach and process that is collaborative in partnership with the insured.

O'Keefe: Price is important, no doubt, but insureds should look at each insurer holistically and decide which best meets their overall needs. The reality is that not every insurer is the same when it comes to policy terms, the due diligence process, industry-wide expertise, underwriting counsel, and the use of exclusions to pare back risk. The actual real world price difference in premium is usually not significant if another insurer can fulfil other important goals. While providing tremendous overall value, the product is not cheap, and you are tying yourself to that insurer for a significant period. You should make the best overall selection for the deal and the business. Claims are an important aspect of this experience too. The best insurers approach claims not as a necessary nuisance, but rather as the core reason why insurance is bought in the first place. Legitimate claims should be paid. The insured should feel comfortable with the insurer's claims approach and general reputation for paying claims before binding a policy.

Lessman: While cost is a key consideration in determining an insurer, ease of underwriting and a positive claims experience should be given more weight. However, when pricing considerations are done irrespective of other important factors to customers, such as a carrier's innovations, which speaks to an insurer's long-term commitment to a market or product, business resiliency, technical capabilities, and enterprise risk management, the money saved may prove to be immaterial. Cheaper is not always better – price considerations need to expand much deeper into capabilities and commitments. While a smooth underwriting process is very important, the claims process is just as important. The carrier must deliver excellence across the claims experience after the transaction, with the support of seasoned attorneys and a claims group with specialised expertise.

Rittberg: Work with your insurance brokers to understand M&A insurance providers' process and appetite for risk. Understand how much experience providers have with consistently and commercially delivering policies for fast-paced transactions and paying claims. A collaborative policy underwriting process with a carrier who 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. Also ask who stands behind policies, how many times the provider has made multimillion-dollar claims payments, and what is their claims handling philosophy. M&A insurance claims often include complex legal, accounting and valuation issues related to breach and loss, and real claims experience is tremendously important to achieve efficient resolutions.

FW: How do you expect transactional risk management to develop in the years ahead? What changes do you anticipate in attitudes, strategies and techniques?

Kearns: The market for transactional risk management, which is still less than two decades old, will continue to evolve as a meaningful risk transfer tool in M&A transactions and for standalone risks presented by tax liability and litigation. R&W insurance, while the most mature of the three insurance offerings, still has a significant amount of runway of first-time users of the product, especially where the benefits of the product continue to be demonstrated through meaningful claims

solutions. The continued maturing of these insurance offerings will bring with it improved data and analytics, particularly as they relate to claims. Claims experience data will ultimately shape breadth of coverage, limits deployment and adequacy of pricing, including retentions. Improved data and analytics will also be beneficial to the continued development of the underwriting opportunities in the contingent liability space, particularly with respect to coverage for litigation risks.

Lessman: In the coming years, we believe transaction insurance will continue to be a sought-after product with continued growth. R&W insurance will be used more frequently, as companies become even more familiar with the coverage. The benefits it provides to both buyers and sellers, such as smoothing M&A negotiations and improving deal outcomes, are unprecedented. Moreover, we expect the due diligence process to become easier as parties involved will have a better understanding of not only the product, but also the diligence needs during the process. Technology will continue to play an important role in the future, fuelling ease of doing business. Carriers will need to leverage the latest technologies to continue enhancing the underwriting process. From a customer service perspective, this means balancing technology with a personal touch.

Reynolds: Now that R&W insurance has gained widespread acceptance, I expect a growing percentage of M&A deals to involve such insurance. Transactional risk insurance is a cost-effective way to manage the long-term residual risks associated with M&A. It enables buyers and sellers to move on and deploy their capital elsewhere without tying up capital in cumbersome escrow accounts or otherwise account for the residual contingent risk associated with M&A transactions. Awareness of tax indemnity insurance is not yet as high. However, some of the same factors that have driven growth in R&W insurance are likely to increase the use of tax insurance. Transactional risk brokers are becoming more familiar with tax insurance and partnering with tax risk experts. Going forward, I anticipate growing adoption of tax insurance, not only in the M&A context, but also for tax credits and balance sheet management.

O'Keefe: Innovation and creativity continue to drive the product. What has always impressed me the most about this field is the way that practitioners are always trying to find new ways to innovate and expand the use of R&W insurance. The perception is that insurance is old and stodgy, but nothing could be further from the truth. We continue to hear creative ideas from insurers and brokers about ways that the product can be used tomorrow, and we expect that will continue in the years ahead. We also anticipate that as the number of carriers increases, and big law firms out-do each other to pay associates and partners greater financial compensation, insurers may rethink their approach to staffing R&W shops. Traditionally, insurers have looked to the ranks of corporate law firms for new talent. But this is by no means a requirement and we have found that some of the best in this field are those that have backgrounds in other areas. After all, the field is primarily concerned with risk analysis. Good underwriting counsel can explain the law. And many lawyers do not have an innate ability to judge risk — if anything, lawyers can be too risk-averse. We anticipate that insurers may look at unique approaches to talent cultivation in the years ahead.

Rittberg: The M&A market is very active today, perhaps the busiest in history. In the short term, we expect transactional risk management to continue to incorporate transactional insurance to efficiently and effectively close deals. Perhaps this boom period could eventually lead to a rise in distressed deals or bankruptcy-related transactions, for which insurance could help buyers get comfortable with the liabilities they are taking on with those businesses. Products will be used more frequently for strategic acquirers that have not adopted the products as much as private equity buyers in the past and in the lower middle market. Finally, we expect claims handling data and procedures will continue to improve and partnerships will strengthen between insurers and insureds.

Shirley: As the value of transactional insurance has been established for some years now, parties will not only increasingly utilise it and recognise its value but may also look to it as a way of allocating risk in less mainstream areas such as 'fund to fund' or 'public to private' transactions. There may also be a broadening appetite, geographically and sector wise, as markets look to explore traditionally underserved areas. As the number of policies increases, the expertise in claims handling will become more important and we anticipate this will become a key part of the appointment process.

Shihab: There are exciting times ahead. M&A has been around since 1708, when Dutch East India started acquiring its competitors. In contrast, transaction insurance only became a workable solution for M&A roughly 10 years ago, and widely used only five years ago. Given the inherent risk relating to an acquisition, there are so many facets where transaction insurance can be of use. W&I insurance and tax and contingent risk will continue to develop to give a near-risk-free risk transfer. The specialisation of the product will also increase to cater for more scenarios – and not only in standalone M&A. Fund wind-down policies will be more widely used. Specialist tax products, such as tax return insurance, will become usable and deployed for non-diligenced tax years. The list goes on. Purchasers, sellers and their advisers should have a lot more tools at their disposal throughout the M&A process. We really are at the tip of the iceberg. ■

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