MARSH

THE SELL-BUY FLIP

SELLER INITIATED WARRANTY & INDEMNITY INSURANCE IN PRIVATE MARKET MERGERS AND ACQUISITIONS

CONTENTS

INTRODUCTION

It is increasingly common in the private company market for entities and individuals who are disposing of an asset or shareholding to seek to restrict their potential post-sale liability. Claims for breaches of warranties given by the sellers and management under the Sale and Purchase Agreement (SPA) are on the rise, and corporates and financial investors need to understand the mechanics behind the complex world of transactional risk insurance.

There is now a clear bias towards limited or no recourse deals, driven by the desire by sellers to achieve the holy grail of a 'clean exit'. This penchant for nil recourse transactions has seen an increase in the number of transactions where the seller(s) requires the buyer(s) to take out a buy-side warranty and indemnity (W&I) insurance policy.

This process for the procurement of W&I insurance has, in the world of transactional risk insurance, come to be described colloquially as the 'sell-buy flip'. Although the sell-buy flip has overwhelmingly been a feature of transactions where the sellers are private equity backed, from our experience it is becoming increasingly common amongst corporates sellers, in order to facilitate a clean exit.

The purpose of this paper is to outline:

- The steps involved in the sell-buy flip.
- Some provisions that are included in SPAs where the use of W&I insurance and a sell-buy flip is being contemplated.
- The potential pitfalls in running a sale process that involves a sell-buy flip.
- Tips and tricks to mitigate these potential pitfalls (or eliminate them completely where possible).
- Some global trends in relation to sell-buy flips.

THE STEPS INVOLVED IN THE SELL-BUY FLIP

THE PROCESS INVOLVED IN THE PLACEMENT OF A W&I INSURANCE POLICY IN A SELL-BUY FLIP SCENARIO IS TYPICALLY UNDERTAKEN IN **TWO** DISTINCT **STAGES**.

STAGE 1

The broker is engaged by the seller to advise on the appropriate insurance structure and agree a strategy in relation to the approach that is to be taken to the W&I insurance market. The selected insurers are typically required to sign a confidentiality or non-disclosure agreement before receiving any information in relation to the transaction.

The broker will then prepare a submission to go to the W&I insurance market that will include all pertinent details of the transaction, the advisors to the seller(s), timing and coverage requirements, and a draft SPA. After reviewing those materials, those W&I insurers who have appetite for the risk will issue non-binding indicative terms that will include preliminary pricing and outline the initial coverage position (including the insurers' views as to the insurability or otherwise of the warranty suite contemplated under the draft SPA).

The broker then collates insurers' responses and prepares a report for the seller(s), including the details of coverage and pricing received, details of the insurer appetite, solvency ratings and capacity of each of the markets. It would be usual to expect to receive non-binding indicative terms from the W&I insurers within two to three days following receipt of the submission and supporting documentation.

Following consideration of the indicative terms from the W&I insurance market, the seller(s) will then instruct the broker to engage an insurer. The seller(s) will be required to enter into an expense agreement with the insurer, whereby they agree to cover the cost that the insurer incurs in engaging external legal counsel, but that cost will only have to be paid by the seller(s) if the insurance is not ultimately taken out.

The broker will then proceed to prepare a memo to be included in the virtual data room, outlining the process, cost, and timing involved in putting the W&I insurance in place. At the same time, the insurer and their external legal counsel will be provided with access to the virtual data room and begin reviewing the contents of the virtual data room, including any vendor due diligence reports that may be available.

STAGE 2

Following selection of the preferred bidder, the insurance procurement process is then flipped to the buyer, at which point the broker's engagement with the seller(s) is concluded and engagement with the buyer commences. The broker then acts for and on behalf of the buyer in order to finalise the placement of the W&I insurance, which can be bound and incepted either at signing or completion of the transaction, depending upon the point in time the warranties are given in the SPA, the timeframe between signing and completion and whether there are any particular regulatory requirements that need to be fulfilled in order for the transaction to proceed.

During Stage 2, the insurer (and their external legal counsel) will conduct high-level due diligence on the transaction. This involves a desktop review of the key transaction documents, including the SPA, the disclosure letter (if applicable), and any ancillary contracts required to facilitate the deal (such as shareholder agreements).

The insurer and their external legal counsel will concentrate much of their energy on reviewing the due diligence materials prepared by the buyer(s). This will include all internal due diligence reports prepared by the buyer(s) as well as any external legal, accounting, tax, environmental, or other due diligence reports.

Following their review of the due diligence materials, the insurer will issue a series of questions to be addressed by the deal team members for the buyer(s) and the legal, financial, and tax counsels engaged to advise the buyer(s) on the transaction. Once it has the responses to those questions, the insurer will then be in a position to form a view on the coverage it is prepared to offer in relation to the risk and the broker will negotiate the terms of that cover and the policy wording generally in order to secure the best possible position for the buyer.

Due to the amount of work involved in Stage 2, we would advise clients to expect this part of the process to take between five and seven business days to complete.

COMMON SPA PROVISIONS USED WITH A SELL-BUY FLIP

In a nil recourse structure that uses a sell-buy flip, the SPA will typically be drafted by the legal advisors to the parties to include the following types of provisions:

- That the buyer will take out the insurance (often at the seller's cost) to be effective as at the date of the signing of the acquisition agreement to cover loss resulting from a breach of the warranties and the tax indemnity up to a certain limit of liability.
- That the buyer will procure that the policy contains terms that require the insurer to provide the W&I insurance on the basis that:
  - The time limitations and caps and collars (small claims threshold and aggregate claims threshold) will not restrict or limit the buyer's right to recover under the policy.
  - The insurer waives its rights to take subrogated action or claim contribution against the sellers other than in relation to fraud or wilful misconduct.
- That the buyer will not knowingly or intentionally do anything or omit to do anything that would prejudice the W&I cover or result in its cancellation, avoidance, or material change or reduction of the insurance.

Where a deal is structured on a nil recourse basis, the SPA will include additional clauses to stipulate (amongst other things) that the W&I insurance will be the sole recourse for the buyer(s) in the event of any breach of warranty or tax indemnity claim, absent fraud or wilful misconduct by the seller(s).

POTENTIAL PITFALLS IN A SELL-BUY FLIP AND HOW TO MITIGATE THEM

WHEN CONTEMPLATING A PROCESS THAT INVOLVES A SELL-BUY FLIP, IT IS ESSENTIAL FOR BOTH PARTIES TO UNDERSTAND WHAT IT IS THAT THE INSURERS NEED TO HAVE AND WHEN THEY NEED TO HAVE IT IN ORDER TO UNDERWRITE THE **RISK** IN THE **TRANSACTION** AND ISSUE A BINDING W&I POLICY.

From the seller(s)

Initial seller drafts of the SPA and any Information Memorandum (IM) prepared by the seller(s) need to be made available to the insurers from the outset so that they have a preliminary understanding of the nature of the risk they are being asked to consider insuring.

The insurers will want to know the sector/industry in which the target operates, its history and performance to date, the motivation for the divestment by the seller(s), the manner in which the seller(s) are proposing to conduct the sale, the proposed timeline for signing of the SPA and completion of the transaction, the likely small claims and aggregate claims thresholds, the prospective caps on liability that the seller(s) would be willing to agree and the anticipated limitations that will apply to warranty claims and claims under any tax indemnity.

Access to the virtual data room established for the seller(s) to disclose information and documentation about the target is also critical. As soon as the virtual data room is ready to be opened to the potential bidders, it should also be opened to the insurer and its external legal advisors so that they can review the scope of the disclosure contemplated by the seller(s) and commence their high level review of the contents of the virtual data room.

Although not essential to the underwriting process, to the extent any vendor due diligence has been conducted, affording the insurer access to those reports (legal, tax, financial, environmental etc.) will greatly assist in providing them with a solid basis upon which they can direct their underwriting focus and narrow that focus to the most important elements of the risks that might be relevant to the operations of the target.

From the buyer(s)

The most critical materials the insurers require from the buyer(s) once the process has 'flipped' from the seller(s) are their due diligence reports. It is integral that these are provided as soon as possible (in draft initially is fine) after exclusivity has been granted to the buyer(s) and that they are comprehensive and substantial in their scope and content.

It will not be acceptable for buyer(s) to simply not conduct due diligence in a particular area of the operations of the target because insurance is 'on the table'. If it is not covered in the scope of the diligence undertaken by the buyer(s) and their professional advisors, it will likely be excluded from cover under the W&I policy.

Access to the buyer deal team members and the external legal and tax advisors is also critical in order for insurance underwriters to get comfortable with the nature and extent of the risk that they are being asked to insure. They will need to be able to address the underwriting questions that are issued and possibly participate in calls with the insurer and its counsel in order to enable them to fully explore their underwriting options and reach a view on policy coverage.

External advisors to the buyer(s) need to be aware that delays in the provision of their professional reports could push out the time frame required to place the insurance for their (and their broker's) mutual clients.

GETTING THE INSURERS' BUY-IN AND COMMITMENT

Insurers will only be required if the underlying transaction proceeds. In an auction situation, where there are multiple bidders for the target, the stakes are high for an insurer. Convincing the insurer to engage with multiple bidders before exclusivity has been granted is a tough sell as it would effectively mean they are doing twice (or three times) the amount of work for only one premium.

When the market is busy and insurers have a high workload, they are far less inclined to agree to underwrite multiple bidders.

Where a transaction is time sensitive, as so many of them tend to be, and there simply will not be enough time to enable the insurer to effectively underwrite the risk and issue a W&I insurance policy within the requisite parameters of the deal, insurers have, on rare occasions, agreed to run multiple underwriting streams (utilising information barriers between underwriters to maintain confidentiality), however, they will increasingly only do so on the proviso that the bidders agree to pay the insurer a "break fee" in the event that they are not ultimately selected as the buyer.

CASE STUDY

An Australian company specialising in the installation of fire safety equipment decided to sell the company to an overseas acquirer. The warranties contained in the SPA were given on a non-recourse basis as the majority shareholder, being a PE firm, they were seeking to wind-up post completion and realise their investment.

W&I insurance was structured into the transaction by the sellers as the sole recourse mechanism for a breach of warranty claim by the buyer. Buyer side W&I insurance for full transaction value was put in place for the tax warranties/ indemnity and general warranties for a period of six years and one and a half years respectively.

The policy was structured on a partial tipping basis (that is, the retention dropped to **0.5%** of the transaction value once claims reached **1%** of the transaction value) to dovetail with the retention structure reflected in the SPA.

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THE DEVIL'S IN THE DETAIL

Insurers will be willing to provide initial indications of pricing and coverage based on limited information in Stage 1 of the process. However, in order to complete their underwriting and issue a bindable policy, insurers will not only require access to the buyer due diligence reports but also want to receive copies of the SPA as it turns between the parties and the negotiations progress in relation to the scope of the warranties and the tax indemnity, including the limitations.

Often the suite of warranties in stage 1 of the process is very seller friendly, with limited warranties and a tax indemnity that may not necessarily go as far as the buyer(s) will ultimately seek to be included in the deal.

As such, the form of the SPA and the scope of the warranties and the tax indemnity that is ultimately agreed may have changed significantly by the time it comes to effecting the W&I insurance.

The result is that an insurer's coverage position may be quite different from that which was initially provided as a result of augmentation of the warranties and the development of them to a more balanced commercial position. It is important to appreciate that W&I insurance is not designed to be used as a substitute for a balanced negotiation between the parties about the scope of the warranties and the position under the tax indemnity. Insurers will want to be satisfied that neither of the parties to the transaction have used W&I insurance as a substitute for the ordinary negotiation process that would have taken place if the insurance was absent.

Although it is fairly rare, where the position under the SPA moves dramatically from that which was in existence at the time the insurer issued its indicative terms to the seller(s), it is possible that the insurer may also seek to increase the pricing for the coverage it is being asked to provide. As such, the parties to the transaction need to be aware that the ultimate cost of putting W&I insurance in place is not finalised until the transaction documents are ultimately agreed and the insurer states that it is prepared to take on the risk.

In addition to the premium and whatever payment is due to the broker for the placement of the risk, there will likely be taxes (including goods and services tax (GST) and stamp duty) that are payable.

Insurance premium taxes will ultimately depend upon the domicile of the insured and this may not be known until the preferred bidder is selected.

The methodology for what a broker might charge for a W&I placement varies, with some operating on a fixed fee model and others on a commission basis.

The responsibility for payment of the premium for W&I insurance will ultimately be a matter for negotiation between the parties. It is not unusual, however, to see the seller(s) agree to bear the costs involved in the placement of the insurance in a sell-buy flip scenario.

TIMING - PERCEPTION VERSUS REALITY

In reality, the underwriting process for a sell-buy flip does not begin in earnest until Stage 2, when the broker has engaged with the preferred bidder, an insurer (or number of insurers where it is a large program of insurance) has been selected, and the preferred bidder has made all of its due diligence materials available to the insurer(s).

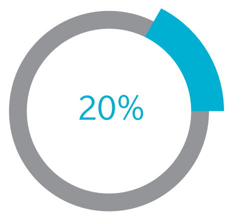
There is a common misconception that there can be a delay in completing the placement of W&I insurance in circumstances where the buyer decides to appoint a different broker to the one that was initially engaged by the seller(s).

If the procurement process has been structured correctly, and assuming that the broker appointed on the part of the buyer is sufficiently experienced, the election by the buyer to use their own broker to finalise the placement should not have an adverse impact on timing.

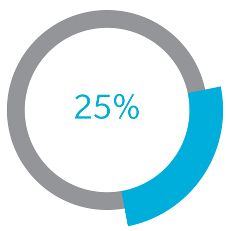
Experience suggests that sellers are reluctant to proceed to appoint a preferred bidder who will not accept W&I insurance as the sole recourse for breach of warranty and indemnity claims.

Marsh polled some of the largest and most experienced underwriters in the W&I insurance market in order to get some indicators and trends with regard to sell-buy flips.

PERCENTAGE OF POLICIES PLACED INVOLVING A SELL-BUY FLIP



MARSH ASIA-PACIFIC
2014 (year-to-date)



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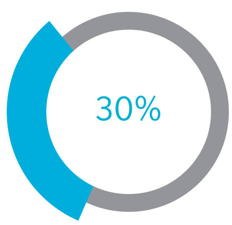

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