Private M&A 2022

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LEXOLOGY
Getting The Deal Through

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Lexology Getting The Deal Through is delighted to publish the fifth edition of *Private M&A*, which is available in print and online at www.lexology.com/gtdt.

Lexology Getting The Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique Lexology Getting The Deal Through format, the same key questions are answered by leading practitioners in each of the jurisdictions featured. Our coverage this year includes new chapters on Latvia and Spain.

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Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Lexology Getting The Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We also extend special thanks to the contributing editors, Will Pearce and Louis L Goldberg of Davis Polk & Wardwell LLP, for their continued assistance with this volume.

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Riders on a storm: signs of a hardening M&A insurance market?

Piers Johansen and Dominic Rose*

Aon M&A and Transaction Solutions

Blink and you missed it: the snap-back moment in M&A activity from the darkest days of lockdown as deal value across all sectors in Europe, the Middle East and Africa (EMEA) almost doubled on catapulted deal volumes ('Deal Drivers: EMEA HY 2021', *Mergermarket*). A similar trajectory in the global M&A market continued through the summer, as the Financial Times reported in early September 2021 that global deal-making reached almost US$4 trillion since the start of the year, approaching the pre-financial crisis record of US$4.3 trillion set in 2007.

In one sense, it's a familiar scene: a benign macroeconomic environment, buoyant capital markets and heaps of private equity 'dry powder' seeking yield. Add a game-changing global pandemic into the mix – surfacing opportunities, catalysing upswings in investment appetite and emboldening corporate strategy (not to mention a deal community mostly cooped up at home!) – and a benevolent M&A deal-making storm brews.

The flow of insurance capital to meet this demand has continued at an unrelenting pace, with the pool of warranty and indemnity (W&I) insurance, tax insurance and contingent risk insurance (together, 'M&A insurance') broadening and deepening through the pandemic as new providers of capital –seeking their own yield – entered the market.

What just happened?

In the leaner times of the early pandemic, insurer pricing and coverage remained highly competitive, as these new arrivals and the relative dearth of deals kept insurers hungry for business.

Fast forward to the first half of 2021, however, and the narrative changes: deal flow into the M&A insurance market from the second half of 2020 into 2021 has been at sustained peak levels, and the supply of insurance capital has shown some signs of struggling to keep up with demand. Aon's experience of the deal tide across EMEA reflects this, with almost US$13 billion in M&A insurance limits already placed in the year to August 2021 – an amount greater than or equal to the M&A insurance placed by Aon across the region in any full year period to date, except the US$14 billion placed in 2018.

One theme highlighted in 'Deal Drivers: EMEA HY 2021' by *Mergermarket* is the scale of individual transactions across the region, with 16 deals worth €5 billion or more being announced in the first half of 2021. Aon's own experience of arranging W&I insurance on larger deals echoes this, with placements executed on four separate deals, each involving an enterprise value (EV) of US$5 billion or more in the year to August 2021 (including one mega deal with an EV of more than US$10 billion), such volume being equivalent to the aggregate of the US$5 billion EV deals on which Aon placed M&A insurance in EMEA for the whole of 2018 to 2020 put together.

Capacity and bandwidth constraints

The broader swell in deal volume has prompted temporary market capacity and bandwidth constraints, with W&I insurers becoming – out of necessity – more selective about the risks they underwrite and declining transactions that would have been within their risk appetite not long previously.

This increase in declinatures marks a noticeable, if likely short-lived, shift in terms of the availability of W&I insurance to support deal-making and has come as a surprise to some clients and advisers. Deals may be declined for various reasons, but not infrequently we have seen a diminished appetite among insurers where a transaction (individually or in combination):

- has a very tight time frame;
- is smaller, perhaps 100 million or less in terms of EV or requiring policy limits of less than 10 million (in principal currencies);
- involves a jurisdiction perceived as more challenging, such as parts of Africa, some former Soviet republics, Latin America or Turkey;
- is in a sector seen as relatively high risk, such as pharmaceuticals, mining and certain financial services; or
- predominantly involves 'internal' due diligence carried out by the buyer's own team rather than a more formally commissioned third-party exercise.

This squeeze on bandwidth, coupled with a general uptick in claims activity, has resulted in a broad increase in pricing for W&I insurance in EMEA this year, ranging from a 'rate on line' (the cost of insurance expressed as a percentage of the limit purchased) of around 0.6 to 0.8 per cent for real estate deals through to nearer 2 per cent for some of the more expensive operational deals (subject to the caveat that sector and jurisdiction appetite can be quite localised, resulting in notable pricing variances within different parts of the market for comparable risks).

Coverage

Where W&I insurers have offered terms, the golden thread to achieving quality W&I coverage remains, as before, appropriately scoped, substantive due diligence on all relevant areas of the target business, supported by a sound process.

Internal due diligence (a potential constraint referred to above) is not itself an insurmountable concern, but it is important to address this sufficiently, and early on in the process, to ensure underwriters are comfortable with the approach. Key considerations include ensuring that the diligence has been sensibly scoped, carried out by individuals with appropriate and relevant expertise and presented in a sufficiently clear, tangible format available for underwriter review.

It is important that the due diligence exercise performed is commensurate with the scope of warranties sought by the buyer in the sale and purchase agreement (SPA). While the commercial focus for such internal diligence may well, understandably, trend towards the go-forward integration of the target business (likewise an important consideration for the W&I underwriter in assessing the deal's overall appeal from a risk perspective), the target's historical liabilities, performance and other areas to which warranties sought in the SPA relate should not be overlooked in the process.

Cyber is viewed as a key business exposure, given increasing reliance on technology platforms, and news reports of global hacking events – such as the Colonial Pipeline, Microsoft Exchange Server and Florida water supply incidents – are a regular reminder of this. We see increased emphasis on cybersecurity, both in terms of the due diligence required and the level of cover that is available. For instance, W&I underwriters are requiring enhanced levels of due diligence of target companies' cybersecurity and cyber insurance arrangements.

Where there is a perceived vulnerability in a target company's cybersecurity, underwriters are likely to decline to provide cover for breach of warranties relating to cybersecurity and data protection. In addition, they may seek to impose a general cyber exclusion, which would deny cover for loss arising from breach of warranty to the extent caused by a cyber event. This is partly driven by underwriters' concerns about cyber issues generally, and partly by the requirements on Lloyds' insurers to proactively manage their 'silent cyber' exposures (where cyber risk in operational insurance policies is neither expressly covered nor excluded, thereby creating coverage uncertainty for both insurer and insured).

A comprehensive approach to understanding the operational and technical areas of cybersecurity in terms of maturity profile, vulnerabilities and scalability, and assessing cyber risk and mitigation, is key to advising clients on how cybersecurity can impact a business – in terms of its performance, valuation and risk – as well as enhance it, to support value creation.

Impact on deal strategy

The capacity and bandwidth challenges referred to above can have a deal execution impact from a variety of perspectives. In an auction context, where sellers often look to enhance the competitive process by structuring a 'stapled' W&I insurance package to present to buyers, sellers will need to allow more time in the deal process for presenting an opportunity to insurers and reviewing the proposals received; flexibility of approach in running multiple buyers will also be important, given the limited insurer bandwidth to staff separate 'trees'.

It is also worth bearing in mind that insurers' non-binding W&I terms are generally stated to be effective for a period of 20 to 30 days; where there is a delay in the seller's auction process, it is prudent – in the current climate, especially – to check periodically that their terms hold.

Auction sellers taking the opposite approach – leaving buyers to make their own W&I insurance arrangements – may find that buyers struggle to obtain those terms as readily as before, thereby lessening the competitive nature in such process.

From the buyer's perspective, differentiating a bid with W&I insurance could prove harder to achieve, and opting to arrange a W&I insurance solution after a pre-emptive bid involves more deal risk.

Tax insurance in M&A

Enquiries in the tax insurance market have increased significantly across EMEA, as clients and their advisers have generally become more familiar with the strategic and value benefits that tax insurance can provide in both a deal and stand-alone context, and have sought to reduce uncertainty around their tax positions.

The 'search for certainty' led to a sustained increase in the demand for tax insurance through 2021, stimulated by three key drivers. First, the perception that challenges from tax authorities may be more likely, given widespread national budget deficits arising from the costs of responding to the covid-19 pandemic. Second, and more broadly, the global ambition to counter perceived tax avoidance, with tax authorities becoming less prepared to offer the comfort previously provided through clearances or tax rulings. Third, of course, there has, as referred to above, been a burgeoning M&A market.

Pricing and terms in the tax insurance market hardened slightly during 2021, coinciding with an increase in demand for higher limits (above 100 million, in principal currencies); that said, the cost of insurance remains generally competitive for the more attractive tax risks, which can benefit from pricing as low as 2 per cent of the limit insured.

Areas of note, on which we have observed clients and advisers seeking greater certainty, include cross-border investment structures, forward-looking cover for future dividend and interest payments and tax risks already under audit.

Cross-border investment structures

In recent years, European tax authorities have challenged certain investment structures, including those sometimes used in private equity arrangements where an overseas holding company, often based in Luxembourg or the Netherlands, receives dividends or interest from a business operating in a different country. The challenge made by tax authorities is often that withholding tax should be applied to those payments because the holding company is not the beneficial owner of the dividends or interest if such amounts are immediately redistributed further up the chain of ownership, and the recipient had no economic function within the corporate structure.

A number of enquiries resulting from the line of 'Danish cases' have focused in particular on the 'principal purpose test', the adequacy of 'substance' and beneficial ownership, as clients and their advisers seek to mitigate the uncertainty arising from the approach that some tax authorities have taken in applying withholding taxes on payments of dividends, interests or royalties, which has been perceived by some to be analogous to moving the proverbial goal posts.

Forward-looking cover

The tax insurance market has shown signs of further innovation by being prepared to cover the risk of withholding tax being levied on future dividends paid by a target business (assuming no change in law or in the investment holding structure), thereby allowing a buyer for that business to bid with greater confidence and certainty. This represents a further illustration of the way in which the tax insurance market can respond favourably to market demand by helping to reduce deal uncertainty as well as improve visibility on future cash flows

Risks under audit

Insurer appetite for risks already under audit, or where an assessment has been raised by the tax authority, has historically been very limited. Since 2020, however, there has been a positive shift in appetite and – within certain parameters – more insurers are now prepared to consider risks where a tax authority has launched an enquiry, or made an assessment or adjustment, in relation to a particular case.

As with any risk, the availability and terms of cover remain fact-specific, and pricing for risks under audit generally trends towards the higher – contentious – end of the cost spectrum for tax risks. Conduct rights in relation to the challenge and litigation process represent a key focus point for insurers for this type of risk.

Capital continues to flow to support the demand for tax insurance, which has matured over recent years to become a more recognised solution that is capable of adapting to help create value through capital efficiency and address an increasing thirst for certainty in unpredictable times.

Contingent risk: pensions risk in M&A

Consistent with the 'search for certainty' theme referred to above, we have seen increased appetite for contingent risks related to M&A, such as UK Pensions Regulator risk. For instance, earlier this year an overseas client was buying a UK business from a corporate seller where, post-completion, the seller would retain two closed underfunded defined benefit pension schemes.

The buyer's due diligence identified that certain employees of the target who were transferring with the business in the M&A deal had accumulated benefits in the schemes. The buyer sought specialist advice on the UK Pensions Regulator's discretionary powers to impose indirect funding liabilities on the target business once the buyer had acquired it (direct funding liabilities not being a concern owing to the structure of the deal).

On a worst-case basis, the overall liability could have been more than three times the deal value. The buyer was concerned about a potentially more hawkish regulatory approach in this area, given recent public statements by the Pensions Regulator and an anticipated change in the UK pensions legislation.

As an identified, known risk, this regulatory concern would not have been covered under a standard W&I policy. The risk quantum was potentially catastrophic in terms of materiality to deal size and, as such, a highly targeted approach to addressing and structuring the risk was required to put in place a multi-layer programme, which gave the buyer sufficient comfort to proceed with the transaction.

Contingent risk: preserving competition damages in M&A

Clients are also exploring the use of judgment preservation insurance to 'lock in' damages awarded to them by first or second instance tribunals, where those awards are being appealed by the defendants. The motivation for doing this varies, with some clients looking to keep an M&A deal in which they are involved as target or seller on track, by providing a solution to the buyer and thereby enabling the seller to receive full value on closing for the damages award.

Other clients may pursue judgment preservation insurance to have certainty over their financial position so they can invest in their business, or they may simply look to de-risk and accelerate payment by taking out a loan secured on the judgment preservation insurance policy rather than wait years for all appeals to conclude.

In one recent case, a client sought to structure a judgment preservation insurance policy to protect a competition damages award of more than €100 million made in favour of a claimant company, where the award was due to go to final appeal after the sale of that claimant company. By looking to preserve its award, the client also sought to preserve the value of the target claimant company, enabling it to negotiate a full price in the sale, which needed to complete before final resolution of the litigation.

Multiple insurers were involved to achieve the total programme, or 'tower', of insurance, with cover and pricing having to be structured to suit their appetite for, and level of, risk in the tower. A key aspect of this was negotiating the 'retention' amount in excess of which the client would be on risk, with the decision for the client being how small it wished to make its portion of the risk.

In this case, where the risk of loss was non-binary and the appeal court would only be likely to reduce – but not extinguish – the award (if it interfered with it at all), incrementally increasing levels of cover became more and more expensive as the chances of loss at that level became higher, and it was a commercial decision for the client how its risk–reward calculation should be optimised.

Conclusion

We do not see the turbulence referred to above as the harbinger of a 'hard' market for M&A insurance as compared with, for instance, the directors' and officers' insurance market, where a confluence of significant, sustained claims experience and insurer capital withdrawals recently caused particular stress after a period of softening in that market over many years.

That said, a generation of deal principals and advisers have grown accustomed to an expansive, ever more benign M&A insurance market, as broader deal-making conditions have remained conducive over a sustained period and, until now, M&A insurance has been on a glide path.

We anticipate that there may be more surprises on the horizon if capacity constraints materialise in the fourth quarter of 2021, typically the busiest part of the year for the M&A insurance market, in the event that some W&I insurers hit the aggregate amount of insurance that they are permitted by their capacity-providers to underwrite for the year.

Seasoned practitioners, on the other hand, may view such market forces as relatively positive: a coming of age, perhaps, for M&A insurance where a buffeting from the elements of the deal cycle, coupled with a building profile of successful policy claims, helps encourage firmer roots as a distinct class of deal-oriented insurance.

In the meantime, successfully getting deals through from an M&A insurance perspective will require more preparation, positioning and time to ensure that the client's risk competes effectively for the insurance capital required. Not only does a bidder need to differentiate itself, in the traditional sense, from other bidders in the eyes of the seller; it also needs to differentiate itself from other clients in the eyes of W&I insurers.

* *The authors gratefully acknowledge contributions to this article from other members of the Aon M&A and Transaction Solutions team, including, in particular, Helen Chapman, Robin Ganguly, Joyce Koch, David McCann, Simon Tesselment and Annabelle Trotter..*

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