Mergers & Acquisitions

M&A INSURANCE: A VIEW FROM THE BOARDROOM

AIG®

In the first comprehensive study of its kind, AIG identifies the UK boardroom attitudes that explain why corporates lag behind their private equity counterparts in using M&A insurance. These findings are based on independent research conducted in collaboration with Ipsos MORI.*

The suite of solutions offered by mergers and acquisitions (M&A) insurers (including warranty and indemnity, tax and contingent liability insurance) enable buyers and sellers to undertake M&A with confidence in the knowledge that insurance is standing behind certain key risks typically arising in an M&A transaction. Such policies are crafted on a bespoke basis by expert underwriters and brokers to achieve specific commercial and M&A outcomes.

Whilst M&A insurance (and in particular warranty and indemnity insurance) has become increasingly popular amongst private equity buyers and sellers when making investments and divestments, the same cannot be said in respect of corporates undertaking M&A. With some notable exceptions, corporates have been slower to take advantage of the significant benefits insurance brings. Some of the reasons for this are discussed below.

The core objective of warranty and indemnity (W&I) insurance (being the most popular M&A insurance product) is to indemnify the insured (usually the buyer) for loss suffered as a result of a breach of seller's warranty and, if relevant, a claim under an indemnity in a sale and purchase agreement. By transferring warranty risks to an insurer, company directors and boards can execute strategic acquisitions with greater confidence and comfort.

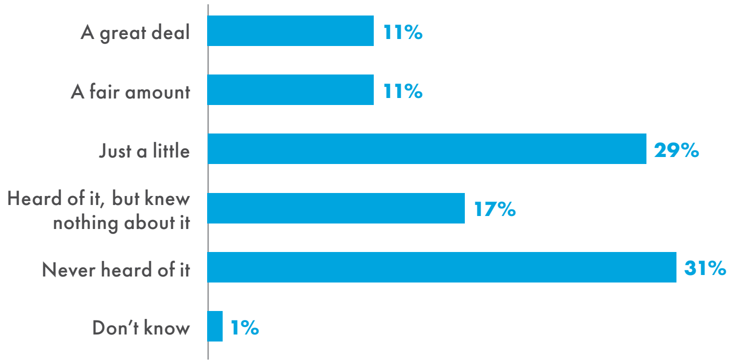
*Methodology

Ipsos MORI conducted 100 interviews with respondents from the top 500 companies by turnover and top 100 by capital employed in the UK. Respondents were executive board-level directors and chairmen. Interviews were primarily carried out face to face (7 were carried out over the telephone) between September and December 2017.

The value of M&A insurance is not fully understood

Findings from our independent research, with senior business leaders at some of the UK's largest companies, suggests that the usefulness of M&A insurance as a risk transfer product and M&A strategic deal tool has not yet been fully articulated to directors at top corporates. Forty-eight per cent of respondents admitted they had not heard of, or had heard of but knew nothing about, this type of insurance, while a further 29% said they knew "just a little".

Question 1: As you may know, it is now possible to buy insurance to cover the risks involved in mergers and acquisitions. Prior to this interview, how much, if anything, did you know about this form of insurance?

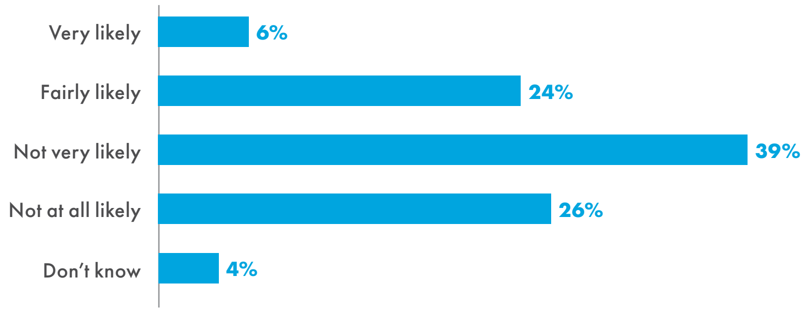


Base: Ipsos MORI British Captains of Industry (100)

Moreover, our research shows that around two thirds of senior business leaders would not buy insurance designed to cover risks borne out of an M&A transaction. When asked why, a quarter of respondents indicated that they had concerns about whether or not such a policy would pay out in the event of a claim.

In fact, AIG's M&A claims statistics for transactions that took place between 2011 and 2016[1] show that claims are reported on one-in-five insured deals. For claims in the $1m-$10m range (just under half of the claims received), the average payout was $4m. This confirms that M&A insurance does in fact respond to claims on a regular basis, and that insurers and brokers alike have work to do in altering perceptions of both transactional insurance and claims response amongst key stakeholders at corporates.

Question 2: Thinking about the benefits of M&A insurance, how likely would you be to buy insurance against potential risks in an M&A situation?



Base: Ipsos MORI British Captains of Industry (99)

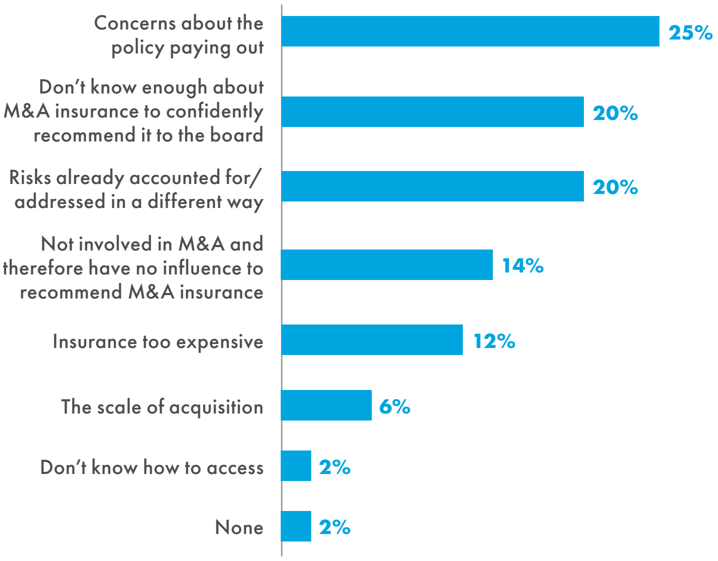
[1] See AIG's Global M&A Claims Study 2018: 'M&A Insurance - The new normal?'

Given that 20% of respondents said they did not know enough about the insurance to confidently recommend it to their board, there is clearly an opportunity for M&A underwriters and brokers to engage more with potential buyers and build understanding about the potential cover and risk solutions available to them. This process is already underway – AIG has witnessed growth in its corporate W&I client base over the past four years, with bound policies up more than 150%.

The US, Northern Europe and Australasia are the most mature markets at present, although demand is growing in Southern Europe, South-East Asia and other emerging markets as boards become more aware of the value of mitigating M&A risks through insurance. Nevertheless, the results suggest that more could be done to raise awareness amongst senior business leaders.

Twelve per cent of respondents were concerned the insurance was too expensive. Competition in recent years has increased choice and brought down the cost of cover. It does however remain a specialist purchase for a high severity type of risk and pricing is reflective of this.

Question 3: What is the main reason why you would be unlikely to buy M&A insurance?



Base: Ipsos MORI British Captains of Industry (65)

AIG's own data illustrates that M&A insurance claims frequency remains highest for the largest, most complex deals. The cross-border nature and inherent scale of these transactions (i.e. mergers and acquisitions with a deal value of $1 billion+) significantly increases the likelihood of a breach of warranty.

This is something our specialist underwriters and claims handlers know to be true, particularly during years with heightened M&A activity (most recently 2016 and 2017) where there is increased competition for attractive target businesses, adding pressure to dealmakers to get transactions across the line.

Given how much is at stake, it is clear the board plays an essential role in ensuring the transaction proceeds successfully. Indeed, in the UK, it is a legal requirement that boards are consciously engaged in, and are seeking to mitigate, the risks encountered on M&A transactions and corporate development agendas.

The need for cyber due diligence

AIG also asked senior business leaders to describe the extent to which the due diligence they had undertaken for M&A transactions over the past three years encompassed a diligence of cyber risks. The results suggest that cyber issues are increasingly being taken into consideration during diligence exercises.

We found that a meaningful 58% of respondents were aware of buyers undertaking due diligence in respect of cyber risks and exposures in M&A transactions over the last three years, testament to the evolving risk landscape. We would anticipate this trend continuing as concerns over cyber exposures carry on rising up the boardroom agenda.

In part, increased board engagement has been driven by widespread disruption from ransomware attacks, high-profile data breaches and new, more stringent, data protection laws in many jurisdictions. We have observed instances where cyber risk assessments directly and indirectly affected the valuation of a target company because of a sizeable data breach.

Given that 42% of respondents had not seen any evidence of cyber diligence (or didn't know), there is clearly more that can be done. What is uncertain is whether the absence of cyber risk assessments in some due diligence exercises is reflective of a lack of commercial concern, or awareness of the magnitude of the potential risks involved.

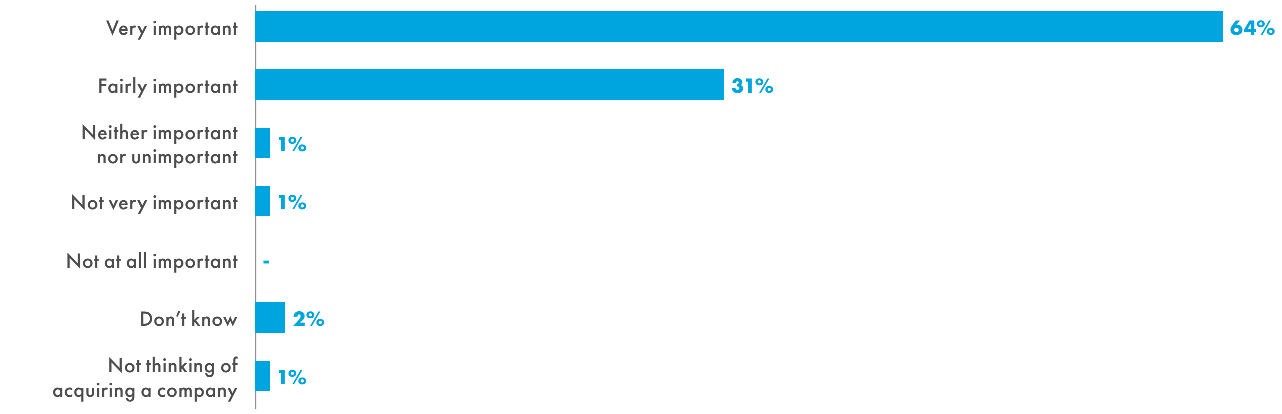
Question 4: Thinking about any recent M&A transactions you have been aware of in the last 3 years, are you aware of buyers undertaking due diligence in respect of the cyber risks and exposures in M&A transactions?

Base: Ipsos MORI British Captains of Industry (100)

Based on our own review of buyers' cyber diligence exercises, we have found that there are a range of approaches and levels of sophistication, and that some are inevitably more thorough than others.

Consideration of cyber risks during acquisitions was recognised as important by 95% of respondents. M&A buyers who are contemplating a potential deal should understand the specific cyber risks of a target, and how these exposures could impact their brand, customer confidence and share price. All companies have varying degrees of cyber risk and boards should be working with internal experts and advisers to implement specific strategies to deal with these risks.

Question 5: How important do you think it is that companies consider cyber risks when making acquisitions?



Base: Ipsos MORI British Captains of Industry (99)

Cyber is a broad and rapidly-changing risk exposure, with rising business losses associated with all types of risk that can impact the intellectual property, products and digital assets of an organisation. Given what is at stake, it is important for companies to regularly review, adapt and update their diligence processes to ensure cyber risks, and other emerging exposures, are taken into account during M&A deliberations.

AIG has seen M&A insurance become a mainstream risk transfer and strategic tool for private equity clients. It is our aim that this trend is replicated for corporates who have embraced professional liability covers, such as directors and officers insurance over the last 30 years.

The insurance industry can redouble its efforts to position and work with clients to ensure that boards understand their intrinsic value in supporting transactions and facilitating what can often be a difficult journey.

Key Questions for Boards

Based on our experience insuring major multinational corporates and private equity firms, we advise boards to ask the following questions when considering buying or selling a company.

Buyer

1. Does the board understand the role and scope of M&A insurance and the typical types of claims?
2. What are the key risks in the business to be acquired and what corresponding warranty protection do we require in order to proceed with the acquisition?
3. Have we considered insurance to enhance our deal terms and avoid the seller having to retain material liability for warranty breach?
4. If the offer to the seller has M&A insurance in place, minimising the seller's liability under the terms of purchase agreement, would this expedite the deal?
5. Could we benefit from insuring tax and contingent liability issues instead of having to ask the seller for indemnity?

Seller

1. Have we fully understood and considered M&A insurance to facilitate the deal and reduce liability?
2. What warranties are we prepared to offer to bidders / the buyer and are such warranties insurable?
3. Are we aware of any tax or contingent liability issues and have we considered insuring these issues to make the deal more attractive?

If you require further information or advice on any topic discussed in this paper, please get in touch with your broker or local AIG contact.

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