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M&A Transactional Insurance: Tools for the Deal Professional

Navigating Transactional Insurance to Mitigate Risk and Protect
Against Erosion of Post-Closing Value and Purchase Price

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1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Jonathan Kim, Partner, **Dechert**, New York

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Transactional Risk Insurance



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Transactional Risk Insurance Overview

- Created to facilitate M&A transactions by addressing issues that are discovered during the negotiation of the transaction or during due diligence that may prevent the deal from closing.
 - Reps & Warranties Insurance
 - Tax Indemnity Insurance
 - Contingent Liability Insurance

Transactional Risk Insurance Overview

Insurance is used to protect or mitigate from two types of risk typically arising from M&A transactions:

- Cover for unknown and unforeseen loss (SPA risk)
 - Representations and Warranties (Warranty & Indemnity) Insurance
 - Seller-side
 - Buyer-side

- Cover for identified and known risks
 - Typically Identified Tax Issues
 - Other contingent risks
 - Can be wrapped around indemnities
 - Stand alone policies (possibly attaching to the target)
 - Non-M&A drivers

Representations & Warranties Insurance



R&W Insurance Overview

Provides coverage for financial losses resulting from breaches of representations and warranties made by target company or sellers contained in purchase agreement

- **Protects an insured from unanticipated (unknown) losses that may arise subsequent to the closing**
 - R&W insurance generally covers all reps in the agreement
- **Either buyer or seller can be insured under the policy**
 - Buyer-side policies – named insured is generally acquisition vehicle (other indemnified parties can be added as additional insureds)
 - Seller-side policies – named insured is the seller(s) – for deals with multiple sellers, named insured is shareholder representative
 - No need for other side to know about the insurance
- **Designed to bridge gap between buyer and seller**

Uses of Reps and Warranties Insurance

Buyers

Risk Management Uses

- Increase maximum indemnity / extend survival period for breaches of reps & warranties
- Ease collection concerns
- Provide recourse when no seller indemnity possible (public company sales, bankruptcy)

Strategic Uses

- Distinguish bid in auction
- Protect key relationships

Sellers

Risk Management Uses

- Reduce contingent liabilities
- Distribute sale proceeds
- Protect passive sellers

Strategic Uses

- Attract best offers by maximizing indemnification
- Include R&W Insurance as the sole remedy in draft agreements in auctions

R&W Insurance – Key Considerations

- Policies are fully manuscripted
 - Limited policy exclusions
- Premiums
 - 2% to 4% of the policy limit (one-time payment)
 - Rates lower internationally
 - Who pays?
- Deductibles
 - Buyer-insured policies often use the escrow as the deductible
 - Seller-insured policies use a negotiated limit – typically no less than 1% - 2% of the Purchase Price
- Underwriting and Claims Handling - Every carrier is different
- Engage broker early in process

R&W Insurance – State of the Market

- Increased popularity
 - 350+ deals done annually (split between corporate and PE buyers)
- Insurance market well-developed
 - Insurers / brokers staffed by former attorneys – work on deal timeframes
 - Policies are customized
 - Underwriting process is streamlined
- Target transactions
 - Transactions between \$10M - \$1B
 - Limits available up to \$300M per deal
 - Generally, no restrictions on industry sector (limited appetite for healthcare deals)
- Insurer commitment
 - Chartis, Concord, Hartford, Ambridge, Beazley, AWAC
 - International capabilities

R&W Insurance – Underwriting Process

- Execute NDA
- Obtain quotes from insurer – 2-3 days
 - Submission includes: recent draft agreement, offering memo, schedules
 - No cost to obtain quotes
- Select insurer
 - Each insurer has pros-cons (role of broker)
 - Insurer due diligence fee payable before underwriting (\$10K-\$25K)
- Insurer underwriting process – 7-10 days
 - High level review of due diligence process (if buyer-side) or disclosure process (if seller-side)
 - Access to legal, financial, tax DD reports
 - Conference call(s) with deal team
- Policy negotiations
 - Concurrent with underwriting process
 - Work closely with outside counsel

Negotiating the Policy and the Applicable Transaction Agreement

- Parties need to understand how the Policy interacts with the Transaction Agreement
- Depending on the particular result that the insured is trying to achieve, it is important to think about the Policy negotiation while negotiating the Transaction Agreement
- Issues to Consider in Policy Negotiation/Transaction Agreement Negotiation
 - Named Insured/Indemnified Parties/Ability to Direct Payment of Proceeds
 - Successors and Assigns under Policy/Transaction Agreement
 - Policy Limits/Caps under Transaction Agreement
 - Policy Retention/Deductible under Transaction Agreement
 - Time Periods: Policy/Survival Under Transaction Agreement
 - Knowledge/Anti-sandbagging
 - Definition of Loss/Damages
 - Right to Defend
 - Subrogation
 - Duty to Mitigate
 - Exclusions

In Closing – Dispelling the Myths

- **Assumption: prohibitively expensive**
 - Representations and Warranties 2–3%
 - Specific Tax issue 4–8%
- **Assumption: High level of retention**
 - 1%-2% of deal value is standard
 - Less than 1% may be achievable, depending on the deal
- **Assumption: Difficult and time-consuming to obtain**
 - Mirrors transaction timetable / workflow
 - Dedicated broking and underwriting teams, ex-M&A lawyers
 - External legal reviews – often not required
- **Assumption: Riddled with exclusions**
 - Reduction in generic exclusions i.e. removal of generic exclusions for product liability / environmental
 - Expanded coverage for known issues
 - Exclusion for “actual knowledge of breach” only; no constructive knowledge theory
- **Assumption: Claims not paid**
 - Economic climate precipitated more claims notifications, more payments by insurers
 - Increased insurer competition means greater pressure to pay
 - In any given year, approximately 5 -10% of policies have claims
 - Claims payments have ranged from \$500k - \$20mm

Tax Indemnity Insurance



Tax Indemnity Insurance Overview

Coverage

- Protects against a transaction failing to qualify for the intended tax treatment
- Helps reduce or eliminate a contingent liability arising from a successful challenge to a specific tax liability encountered in a transaction
- **Issues**
- Feasibility and/or economic benefit of transaction dependent on favorable tax treatment
- While likelihood of potential tax liability/IRS denial may be low, \$ amount of potential liability very high—most sellers will not put up an escrow equal to potential \$ amount; thus, insurance can give buyer this protection

Typical Uses

- 355 Spin-offs
- 338(h)(10) elections/S-Corp Issues
- Cancellation of Indebtedness
- Net Operating Loss Protection
- Successor liability
- Tax-free reorganizations
- Liquidating Trust status
- Capital Gain v. Ordinary Income Treatment

Tax Indemnity Insurance - Overview

Covered Items

- Tax Liability - To Statute Limits
- Fines & Penalties
- Interest
- Legal Cost
- Tax Gross Up

Key Coverage Issues

- Cost – typically, 4% - 12% of policy limit
- Deductible – varies by deal (often no deductible required)
- Underwriting – varies by insurer (similar to R&W underwriting process)

Contingent Liability Insurance



Contingent Liability Insurance

Representations & Warranties (Warranty & Indemnity) Insurance Generally Does Not Address Known Exposures.

- **Three things necessary to insure a risk:**
 - Quantifiable Risk
 - Probability Analysis
 - No Moral Hazard

- **Recent Examples**
 - Successor Liability
 - Specific Indemnities
 - Fraudulent Conveyance
 - Litigation

- **Cost, Limits and Deductibles vary based on particular risk**

Craig Schioppo, Managing Director Marsh

Craig Schioppo is a Managing Director with Marsh's Transactional Risk Group in New York.

As leader of Marsh's Transactional Risk Group, Mr. Schioppo is known as an expert in the insurance of financial and transaction risks, including M&A insurance, tax insurance, and insurance programs addressing regulatory, environmental and litigation risks. He is constantly involved in the development of dedicated insurance products that facilitate mergers, acquisitions and other corporate transactions. He is also involved in negotiating the terms and conditions of all of the Transactional Risk Solutions.

Mr. Schioppo began his career as a Staff Accountant at Anchin Block & Anchin LLP in 1993. After spending two years as an auditor, Mr. Schioppo spent the next five years as a Supervisor in the Tax Department where he was intimately involved in both corporate and individual tax planning and compliance. During his last four years as an accountant, he attended New York Law School as an evening student and was a Notes and Comments Editor of the law review.

Upon graduating law school, Mr. Schioppo spent the next four years practicing corporate and securities law at Kramer Levin Naftalis & Frankel LLP. As a corporate attorney, Mr. Schioppo had a diverse transactional-based practice with significant experience in domestic and cross-border mergers and acquisitions, joint ventures, securities and general corporate matters.

He is a licensed property and casualty insurance broker resident in New York and nonresident in a majority of the United States jurisdictions. Mr. Schioppo is also admitted to practice law in the State of New York. Prior to leaving public accounting, Mr. Schioppo was a licensed C.P.A. in the State of New York. Craig earned his B.S. in Accounting from the State University of New York at Albany (1993) and his J.D. from New York Law School (2000) where he graduated *magna cum laude*.

Mark Thierfelder, Partner

Dechert LLP

Mark E. Thierfelder, chair of the New York corporate and securities group, and a member of the Firm's Policy Committee, concentrates his practice on private equity transactions and domestic and international mergers and acquisitions throughout the U.S., Europe, and Canada. In particular, Mr. Thierfelder represents leading private equity funds and their portfolio companies in a full range of corporate transactions, including mergers and acquisitions, recapitalizations, leveraged financings, restructuring, and reorganizations. In addition, he negotiates, structures, and executes corporate transactions on behalf of strategic buyers and sellers, and has significant experience representing banks and other institutional lenders in leveraged financings and restructurings.

Mr. Thierfelder has been recognized as a leading corporate and merger and acquisition lawyer by the legal directory *Chambers USA*, where he has been described as “one of the most sophisticated lawyers” who “possesses a command of the entire deal process, has great commercial awareness and a good temperament for negotiating with the other side.” He has also been listed as a top private equity and merger and acquisition lawyer for the past five years by *The Legal 500* (U.S.), which has cited him as being “creative, hardworking, and client oriented” with “very good commercial sense.” He is also a frequent speaker on mergers and acquisitions and other corporate and securities topics, and has been featured on CNBC as well as in *The Deal Pipeline*, *Mergers & Acquisitions* magazine, *Investment Dealers' Digest*, *Private Equity Online* and other prominent media outlets.

Mr. Thierfelder has extensive industry experience representing clients in sectors including energy, infrastructure, retail, media and communications, healthcare, fishing, semiconductors, manufacturing, and food and beverage. As a result, he can anticipate and address industry-unique issues that often arise in the transaction process and structure the transactions efficiently.

He is a Trustee of the National Humanities Center, Research Triangle Park, North Carolina. He is also a member of the New York City Bar Association's Corporation Law Committee.

Mr. Thierfelder is a graduate of Duke University (B.A., 1986), Rutgers University School of Law – Newark (J.D., with honors, 1992, Order of the Coif). He is a member of the New York Bar

Jonathan Kim, Partner

Dechert LLP

Jonathan Kim focuses his practice on mergers and acquisitions, corporate finance, and leveraged finance matters. He represents strategic buyers and sellers and financial sponsors in mergers, acquisitions, and divestitures. In addition, he represents borrowers, equity sponsors, and lenders in domestic and international leveraged finance transactions in the United States and Asia, and advises on securities offerings of equity and debt.

Examples of recent transactions on which Mr. Kim has counseled include:

- Expert Global Solutions, Inc. (f/k/a NCO Group, Inc.) in connection with its combination with APAC Customer Services, Inc., and related first and second lien financings of \$995 million
- Arbor Realty Trust in connection with its \$8 billion joint venture acquisition of Extended Stay Hotels from The Blackstone Group
- Connors Bros. Holdings, L.P. in connection with the \$980 million sale of Bumble Bee Foods to Lion Capital
- Kumho Investment Bank and a group of other Korean investors in connection with the acquisition of AIG's headquarters at 70 Pine Street and 72 Wall Street, New York
- Mood Media Corporation (as U.S. counsel) in its \$345 million cross-border acquisition of Muzak Holdings LLC

Mr. Kim is a graduate of State University of New York at Binghamton (B.S., 1999) and Georgetown University Law Center (J.D., 2002). He is a member of the New York Bar.