

GREY PAPER

insights

INDEMNITIES OR INSURANCE?

Getting and maintaining control of M&A transaction risk.

Pilko & Associates Grey Paper

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Pilko & Associates is the industry leading Operational and Environmental, Health, and Safety Risk advisory firm — working with clients in 59 countries and advising on M&A deals worth more than \$600 billion.

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INTRODUCTION

Uncertainty is abundant when negotiating M&A transactions. It's simply part of the process.

But this uncertainty must be contained and managed to increase the likelihood of reaching an agreement and closing the transaction, as well as to limiting ongoing Operational Risk.

During due diligence and negotiation, the traditional risk control tool has been the securing of indemnities against current and future liabilities.

Recently, we've also seen the emergence of specialized Representations and Warranties (R&W) insurance designed to protect against liabilities that may crop up after acquisition completion.

Our transaction clients have asked us, "Which one is right, and for what circumstances?" This Grey Paper explores the differences and how one might be a better choice than the other depending on the type of deal your company is pursuing.

IS THERE REALLY A DIFFERENCE?

Indemnities and R&W insurance are often seen as similar. Both require one party to take responsibility and stand good for the loss of another.

Indemnities outline responsibilities, responsible parties and compensation for future financial loss or damage, giving buyers increased financial security and lower risk.

R&W insurance is a powerful vehicle to protect against financial loss — especially in quick transactions, where vendor due diligence is hard to complete or in "as is, where is" selling scenarios — by protecting buyers that assume risk beyond what they would ordinarily do.

Even though the end result may be similar, sufficient differences between the two warrant careful consideration when determining which one is best for your circumstance and transaction.

TRADITIONAL INDEMNITIES

Well known and understood, Indemnities represent the contract between two parties whereby one party agrees to cover any liability, loss or damage sustained by the other party from some contemplated act or condition, or damage resulting from a claim or demand of a third party.

Principally designed to protect against future financial loss to the seller and buyer, they include items such as:

- Breach of representation or warranty
- Breach of agreement or covenant
- Losses incurred under specific conditions
- Third-party claims
- Environmental damages
- Regulatory compliance
- Gross negligence

Each of these individual terms and conditions are identified, negotiated and agreed upon prior to the transaction completion. Both buyer and seller work hard to be as thorough and comprehensive as possible — adding time and complexity to the negotiation and deal close.

Circumstances created by difficulties in Vendor Due Diligence, seller or buyer cooperation, transaction timelines, asset conditions, jurisdictional challenges and other items may force the consideration of an alternative to traditional Indemnities.

REPRESENTATIONS AND WARRANTIES INSURANCE

The spectre of unknown risks between buyers and sellers has created the Representations and Warranties insurance offering. These policies allow a third-party to assume a portion of the transaction risk, particularly in the middle-market transaction segment.

For different reasons, R&W Insurance may be attractive to both Buyer and Seller: Buyers like the comfort that Insurance provides to help them recover from a third party (insurer) losses that result from a breach of the seller's representations and warranties once any retention has been recovered. Insurers generally require that buyers and sellers each cover half of any retention — motivating

buyers to complete thorough due diligence and sellers to accurately disclose their representations and warranties. Sellers like this type of protection as it allows the seller to leave a relatively small portion of the purchase price in escrow for a short period of time, which provides greater clarity regarding distributions and eases concerns about liability and indemnification claims.

R&W INSURANCE: BUYER ADVANTAGES

Our experience in working with energy transaction buyers points to a host of advantages worth considering in the M&A process. They are:

- *Deal acceleration.* Getting to a successful SPA can happen faster, increasing the bidders chances of success.
- *Deal completion.* M&A negotiations are complex and time-consuming. Cutting out some of the complexity can increase the probability of successful deal completion.
- *Risk simplification.* While the risk doesn't go away, some risks can be shifted to a third-party, thereby simplifying negotiations between the seller and counterpart.
- *Business value protection.* If buying a publicly traded company, insurance may cover risks that would not otherwise be captured in a share sale.
- *Covering unknown risks.* Sellers are increasingly offering "as is, where is" assets, with minimal disclosure.
- *Longer coverage.* The R&W insurance coverage period is often greater than traditional 3-year indemnity protection coverage periods.
- *Indemnity collection.* In jurisdictions with uncertain enforcement, insurance can speed up collection of payments. Similarly, insurers have a higher likelihood of paying claims that sellers otherwise could not.

R&W insurance is an efficient way to protect financial aspects of a deal. In addition, an increased number of underwriters have entered the marketplace in the last five years resulting in lowered premiums (often below 3 percent and retention to below 1 percent of the deal).

R&W INSURANCE: BUYER DISADVANTAGES

As is always the case, R&W insurance may not be the best option in every circumstance. Again, our work with clients in M&A due

diligence and negotiation has revealed the following disadvantages to consider:

- *The hassle factor.* R&W insurance does not remove the number and level of interactions needed to resolve environmental or regulatory issues. The buyer will still need to be involved without the benefit of insurance or seller assistance.
- *Unknown issues.* Some issues may not become apparent until the timeframe between deal signing and closing. These issues may not be contained in any R&W insurance coverage.
- *Insufficient coverage.* R&W insurance doesn't generally cover fraud or misrepresentation. The buyer will need to still pursue a remedy through alternative means.
- *Unknown costs.* Insurers are usually only prepared to quote once a bidder has exclusivity in a deal.
- *Tax advantages.* Insurance may be less tax efficient than indemnities.
- *Inexperience.* Insurers are unlikely to have experience or expertise in remediation or preventative maintenance, possibly leading to higher risk of an adverse event or to increased event magnitude and cost.

R&W insurance isn't a silver bullet. Indemnities are still necessary to cover gaps that insurance doesn't address.

R&W INSURANCE: SELLER ADVANTAGES

The advantages sellers should consider when negotiating risk and indemnities through the use of insurance include:

- *Faster access to cash.* Sellers get their cash faster as escrow periods can be shorter.
- *Access to more cash.* A smaller portion of cash is retained in escrows.
- *Eased concerns.* Sellers can rest easier regarding joint-and-severally liable indemnification claims.
- *Reduced liabilities.* R&W insurance can reduce, limit or eliminate post-closing liabilities for breach.
- *A clean exit.* Redistribution of fund profits with little to no risk of clawback.

R&W INSURANCE: SELLER DISADVANTAGES

- *Losing bidders/buyers.* Strategic buyers often prefer to avoid taking on additional insurance and so the sale may default to PE bidders.
- *Deal size.* R&W insurance can be challenging to obtain for deals in excess of \$2 billion in value.
- *Inexperience.* Insurers are unlikely to have experience or expertise in remediation or preventative maintenance, possibly leading to higher risk of an adverse event or to increased event magnitude and cost.

WHICH IS RIGHT FOR YOU?

Both indemnification and R&W insurance serve to transfer risk, but they do so in different ways. The differences may mean that a seller's duty to indemnify may exceed the limits of insurance coverage.

R&W insurance may allow parties to efficiently allocate risk and increase deal value. It may also be implemented to strategically change the dynamics of a deal in a competitive process and, when considered early in a deal, may be determinative in whether the deal gets done.

Buyers and sellers are advised to take a blended approach to Indemnities and R&W insurance for the reasons stated above. Neither covers all situations for both buyer and seller; however, a blended approach appears to bring benefit to both parties — especially in bringing difficult or complex deals to closing quickly while reducing current and future liability risk.

PILKO & ASSOCIATES

Pilko & Associates knows M&A transactions and how to control buy- and sell-side risk. We have a passion for rapid, dramatic and sustainable transaction success. Our experience in global M&A provides a unique perspective that helps our clients in the due diligence, negotiation and close process — and in post-close Operational Excellence and value retention. We have done this for leading energy and chemical companies around the world.

Energy and chemical leaders have consistently relied on Pilko & Associates to increase and accelerate achievement of control of M&A Transaction, Operational and EHS Risk. Leaders depend on the experience, skill, proven Best Practices and **8IGHT DRIVERS® METHODOLOGY** to find, prioritize and eliminate “hard” and “soft” risks that accelerate M&A transaction success.

Calls us today and let's get started on the journey to your next M&A transaction success.

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ABOUT PILKO & ASSOCIATES

Pilko & Associates provides industry-focused advisory services in three core areas — Transactions, Operational Excellence and Governance & Assurance — to enhance value for our clients and their stakeholders in the chemical and energy sectors. We deliver innovative solutions for publicly and privately-held companies, helping them to identify, understand and manage their Operational Risk and Environmental, Health & Safety needs. For more information, visit www.pilko.com.

