



# M&A Insurance – An Important Aspect of the M&A Transaction Process



The Private Equity (PE) sector has been the driving force behind the establishment of M&A insurance and continues to be a core driver for its development and growth, states Brian Hendry, Head of M&A Insurance at Paragon International.

## M&A MARKET OVERVIEW

The M&A market is as strong as it has ever been, driven by the ongoing cheap debt and continuing difficulties obtaining major organic growth. 2017 was a strong global M&A year, with transaction volumes reaching \$3.9 trillion. Global M&A already reached \$2.5 trillion in first half of 2018, largely led by an increase in mega deals.

It is expected that there will be a solid GDP growth in key economies and firm equity and debt markets will continue to provide companies with confidence to undertake new and transformative M&A transactions. However following the surge in 2018, M&A values are predicted to fall in 2019 and 2020 as global GDP and investment growth slows at the same time as borrowing costs rise in key economies. M&A activity will however peak in 2019 in emerging economies, followed by a cyclical downswing, predicts global law firm Baker & McKenzie.

Private equity has helped shape the M&A landscape and this can be confirmed by sustained high levels of PE deal activity in the first half of 2018. Economic growth, as well as the availability of credit, have been facilitating these levels. Record 'dry powder' (\$1 trillion in capital predicted for 2018) has facilitated fierce competition for limited assets among PE funds (causing valuations to be kept high over a prolonged period). There has also been an increased use of alternative investment models (ie club deals) to spread costs and risks of acquiring assets.

PE has been turning to the insurance market, which has helped funds with their investment and exit strategies. With increased market scrutiny, PE has become more at ease with improved policyholder safeguards such as disclosure and transparency requirements.

With the dramatic growth in transactional risk insurance in North American and European markets, as well as overall growth globally, insurance is being used to close more deals than ever and this trend is not going to subside any time soon, as noted by the major world insurers.

## M&A INSURANCE BENEFITS

### Sellers

- Sellers limit their liability allowing early access to the full deal consideration
- The need for escrow, bank guarantee and hold-back is removed
- The buyer has direct rights of recourse against their policy in the event of a claim
- Clean exit – insurance can replace liability otherwise held by the seller.

### Management

- "Ring Fence" contingent exposure from breaches of warranties and indemnities
- Enables a full suite of commercial business warranties to be provided.
- Re-investment into the target business is safeguarded.

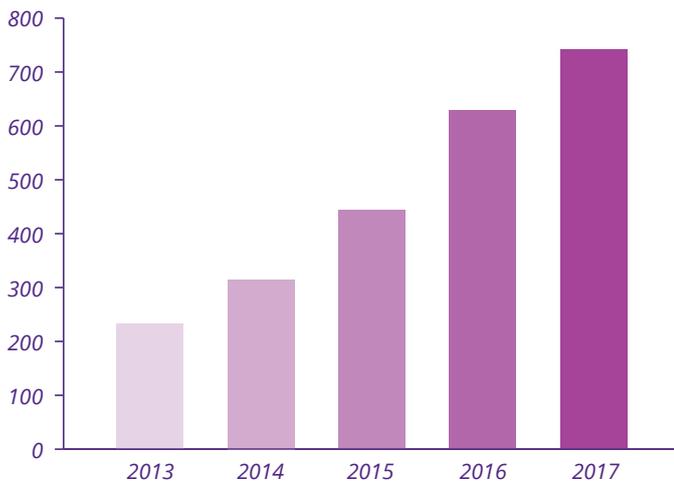
### Buyers

- Direct access to a M&A insurance policy with a limitation package tailored to the buyer's requirements from an insurer with a strong security rating.
- In the event of a breach, there is no need to involve the seller/management in a claim
- Management focus remains on driving the business forward without the 'distraction' of potential claims that could erode the equity that they have worked hard to create.
- Strategic tool in an auction process – to manage seller liability and/or enhance the profile of the buyer's bid.

## WARRANTY AND INDEMNITY INSURANCE FOR PRIVATE EQUITY

In 2017 the Warranty and Indemnity (W&I) insurance market received over 1750 submissions in relation to UK transactions, of which over 700 were insured, equating to a significant volume of all UK M&A. Acquisitions by nature involve a number of different risks and therefore insurance is a way of mitigating those risks and bringing both sides to a final agreement. Whilst the demand for such products is dominated by “mid-market” firms, the product is sector and deal-size agnostic (deals ranging between \$10m-\$10bn).

### Primary policy count development



The use of W&I insurance on UK transactions has been growing by circa 20% per annum for the last five years.

The core objective of W&I insurance is to indemnify the insured (most likely the buyer) for loss suffered as a result of a breach of seller's warranty in a sale and purchase agreement (SPA). By transferring warranty risks to an insurer, company directors and boards can execute strategic acquisitions with greater confidence and comfort.

The PE sector has been a particularly enthusiastic user of the policies. It is viewed as a good instrument for PE funds to boost their internal rate of return (IRR). While predominantly taken by buyers of companies, the benefits of the insurance, especially when enhanced with relevant (to the SPA) elements for the sell-side should also be recognised. These benefits can be achieved by using Paragon's bespoke W&I product that provides a number of enhancements in the sellers' SPA negotiation process, including:

- 'Synthetic' warranties and 'synthetic' tax deeds which can be provided in certain instances where sellers cannot provide warranties or tax covenants;
- 'Knowledge scraping' of warranties allows sellers to give warranties qualified to their knowledge which provides a further layer of comfort for the sellers but allows the buyer to have the ability to claim against the insurer under the policy on an unqualified and objective basis;
- Data rooms not being generally disclosed – to the extent the commercially agreed position in the SPA is that the data room is not generally disclosed insurers can stand behind this approach.

Importantly for fund management partners such insurance allows the seller to account for the full value of a disposal at the time of closing as the M&A insurance has managed the otherwise contingent liabilities.

As more PE funds understand the benefits their funds can reap by using the W&I solution it's use as a product will continue to rise.

**Natalie Thomas**  
Vice President

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## ABOUT PARAGON

Paragon has over 45 years of transaction experience providing insurance advisory services to buyers and sellers at all stages of an M&A transaction. Paragon provides services to private equity, infrastructure and real estate funds, corporations, family offices and lenders.

**Paragon have a strong reputation for providing comprehensive advice and delivering the following effective insurance products, including:**

- Warranty & Indemnity
- Reps & Warranties
- Tax
- Litigation Transfer
- Contingent Liability

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## THE M&A TEAM

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