Managing Transaction Risk

Despite current enthusiasm for transactions, both buyers and sellers face a range of exposures during the deal negotiation and after it has been completed. Chief among these are financial statement irregularities and allegations of fraud.

Often during M&A negotiations a gap exists between the level of indemnification that will be offered by a seller and that a buyer will accept.

Representation & warranties (R&W) insurance offers a relatively simple solution, providing coverage for losses arising from breaches of representations and warranties within the context of an M&A transaction.

Demand for R&W insurance has been rising. This is not simply due to the surge in deal numbers. The market for R&W insurance is well established in London and Australia. However, it is starting to increase considerably in North America too, where the size of the market has doubled every year since 2011.

These authors explain that a key driver of demand is from investors entering new jurisdictions and wanting to demonstrate good corporate governance by ensuring that they have adequate warranty protection ring-fencing their investment.

There is a growing demand for policies that cover breaches occurring between the signing and closing of a transaction.

Another trend is the use of the no seller recourse structure, where a seller foregoes any liability with respect to the warranties and the buyer uses the insurance as its sole recourse.

The other, arguably more significant, area of exposure that needs to be considered when undertaking a transaction is what happens once the deal is completed.

Future accounts receivable performance is one area over which buyers have no control and R&W insurance does not provide coverage.

Accounts receivable insurance provides protection for companies that sell goods or services on credit terms and are exposed to the risk of non-payment.

However, while this is a product that has a penetration rate of around 70% in Europe, the take-up rate in the US has been much lower, at around 10 – 15%.

Historically, this is because US trade overseas has been more limited, but also as a result of the 2008 banking crisis where a number of providers arbitrarily pulled coverage.

The market has moved on considerably in recent years by developing more innovative products that better address buyers' needs and concerns.

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Managing Transaction Risk

Deal-making is very much back in vogue. Last year was the busiest ever for mergers and acquisitions (M&A), with volume reaching US $4.7 trillion.

A number of factors are behind this, including increased boardroom confidence, the prevalence of cheap debt (a direct consequence of the on-going low interest rate environment), ample cash on corporate balance sheet and raised in private equity funds, pressure to add scale in a slow-growth economy and a desire to keep up with consolidating rivals.

But despite this enthusiasm for transactions, it is by no means a risk-free process. Both buyers and sellers face a range of exposures during the deal negotiation and after it has been completed. Regardless of the thoroughness of the due diligence undertaken, there is always an element of the unknown.

Unknown issues manifesting themselves after closing could range from "body shots," including legal, intellectual property and environmental issues, which could seriously damage the business, to "head shots," which might prove potentially fatal. Chief among these are financial statement irregularities and allegations of fraud.

Unsurprisingly, savvy investors are looking at how best to mitigate the risks they face through the transaction process and beyond, to achieve greater certainty and peace of mind.

Protection during the deal negotiation

Often during M&A negotiations a gap exists between the level of indemnification that will be offered by a seller and that a buyer will accept. This can often lead to a deadlock between the parties and their advisors.

A representation & warranties (R&W) insurance policy offers a relatively simple solution, providing coverage for losses arising from breaches of representations and warranties within the context of an M&A transaction and transferring certain risks to a third-party insurance company.

R&W insurance can be purchased by a buyer or a seller to protect against the loss or liability arising from an unknown or undisclosed matter.

A seller buys protection against losses suffered in the event that a buyer brings a claim for breach of a representation or warranty. Defense costs incurred by the seller are also covered under the policy.

A buyer-side policy supplements (and occasionally replaces) the buyer's normal contractual recourse against a seller – providing protection against losses arising from a breach by the seller. Each policy is tailored to each unique transaction.

Growing demand

Demand for R&W insurance has been rising. This is not simply due to the surge in deal numbers. Demand has also picked up as deal parties and their advisors have become more familiar with the product.

Awareness of R&W insurance is now greater than ever, while at the same time in certain countries coverage has become broader and pricing has come down as the market has matured with the arrival of new entrants and heightened competition.

The market for R&W insurance is well established in London and Australia. However, it is starting to take off in a big way in North America too, where the size of the market has doubled every year since 2011.

Financial sponsors trading with each other have made up the bulk of the users – around 70-80% – in North America, but corporate (or strategic) buyers and sellers have been getting increasingly involved and are expected to get more so.

Another key driver of demand is from investors entering new jurisdictions and wanting to demonstrate good corporate governance by ensuring that they have adequate warranty protection ring-fencing their investment.

From an insurer's perspective, R&W insurance is a severity, rather than a frequency, product. As such, R&W insurance buyers need to look at potential providers with a number of issues in mind.

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The first is whether the insurers have the necessary balance sheet strength but also, more importantly, whether they have the track record of claims handling and support. With potentially substantial amounts of money on the line, the knowledge that the insurer can and will pay legitimate claims is vital.

A Strategic Tool

Historically, R&W insurance has been used as a reactive tool, deployed in an attempt to overcome obstacles that may arise during a transaction negotiation.

However, it is increasingly being used more strategically, especially by buyers in an attempt to differentiate themselves in a competitive bid process. Its use allows them to propose a much lower escrow from the seller, with shorter limitation periods for potential unknown breaches of warranty.

The insurance steps in to provide the additional protection usually afforded in a deal. On the other side, it also gives sellers a much cleaner exit, enabling them to realize the proceeds of a sale and distribute them to investors as soon as possible.

As product adoption continues, we are seeing the emergence of new trends. There is a growing demand for policies that cover breaches occurring between the signing and closing of a transaction.

In these cases, the loss from the new breach both occurring and discovered between sign and close may sit with the buyer, unless it is covered by the R&W insurance or the buyer has been able to negotiate some other risk transfer or mitigation.

Another trend is the use of the no seller recourse structure, where a seller foregoes any liability with respect to the warranties and the buyer uses the insurance as its sole recourse (with carveouts for fraud and other exceptions).

Protecting your cash flow

The other, arguably more significant, area of exposure that needs to be considered when undertaking a transaction is what happens once the deal is completed. This is something that, during the intensity of the deal process, may not be given adequate attention.

In any deal, the buyer is essentially acquiring a balance sheet, of which the accounts receivable are usually some of the biggest assets. This is the heart that pumps blood around a company and keeps it alive.

If the flow of accounts receivable is impeded, cash flow dries up and the business suffers a hit to working capital, which impedes its ability to grow the company and manage its own payment obligations.

While buyers will perform due diligence and obtain a measure of disclosure, future accounts receivable performance is one area over which they have no control; it is almost impossible to fully understand the issues that are impacting your customers and that may affect their ability to continue to operate in the future.

Yet while some items on a balance sheet can be protected by R&W insurance, going forward accounts receivable are not covered.

But there is a way that buyers can obtain a degree of certainty over their on-going cash-flow – accounts receivable insurance.

Accounts receivable insurance provides protection for companies that sell goods or services on credit terms and are exposed to the risk of non-payment due to their domestic and/or export customer's insolvency, protracted default or political risks that may prevent the buyers from fulfilling their payment obligations.

Choose your product wisely

However, while this is a product that has a penetration rate of around 70% in Europe, the take-up rate in the US has been much lower, at around 10-15%.

Historically, this is because US trade overseas has been more limited, but also because in the fallout from the 2008 banking crisis, trade credit products were accused of being 'fair weather friends' with a number of providers arbitrarily pulling cover.

The insurance industry needed to respond and it did. The market has moved on considerably in recent years by developing more innovative products that better address buyers' needs and concerns.

The use of technology has evolved enormously, giving client management deeper insights into their balances and exposures as well as reducing the administrative burden of policy management.

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However, the most significant development in recent years has been the introduction of excess-of-loss products, which provide policy holders with greater certainty through non-cancellable limits while introducing a level of risk-sharing between the policyholder and the underwriter.

These products also provide flexibility for a company to manage its business with the security of an accounts receivable insurance policy to safeguard its credit team.

Cover with cancellable limits is still on the market and its enduring appeal is clear – it is cheap, readily available and usually comes with a credit management service – but it is time for buyers to evolve and take a broader view.

Trade credit insurance is a vital back-stop to potential losses and to prevent bad debts from accumulating so buyers should be looking to buy substantial quality cover, rather than just shopping around for the cheapest option at each renewal.

Advantages beyond risk protection

There are additional benefits to investing in a quality product. The larger insurers engage holistically across the whole credit management space, helping companies improve the way they view and manage credit risk, rather than just doing it for them, which simply creates dependency.

For those businesses looking to expand into overseas markets, trade credit insurance is becoming an increasingly vital tool. It helps give confidence to push for growth, especially in developing markets where there is often more uncertainty and less security.

In addition, it helps companies get the capital they need to expand; having a policy in place makes it more likely that banks and financing companies will offer their support, making it easier to gain access to better working capital financing options.

At the end of the day, anyone approaching a transaction needs to do everything they can to manage the associated risks.

As today's business world becomes increasingly interconnected and complex, so do the risks that companies face during a transaction and beyond – cyber breaches, environmental liability, product recall and business interruption, to name but a few.

Taking out both R&W and accounts receivable insurance is a smart move but developing a holistic, integrated approach to managing exposures will help to cover all bases, eliminating nasty surprises further down the road.

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