Transactional Insurance

How Better to Manage Litigation Than to Prevent It?

By Joseph DePaul and Jonathan Ziss

It has been reliably reported that mergers and acquisitions (M&A) related litigation is a significant problem for corporate America. In fact, despite fewer acquisitions in the contemporary economy, the percentage of deals that have spawned lawsuits has increased dramatically. Shareholder dissatisfaction with a perceived post-closing diminution of value is one battlefield. Another is the buyer's dissatisfaction with inevitable post-closing contingencies.

Transactional Insurance

The insurance industry has in recent years developed and honed a suite of transactional insurance (TI) products. These can provide an ideal risk management solution to the deal-making community. The use of TI — even its consideration alone — can be the proverbial ounce of prevention. In a real sense, TI advances litigation management to the front-end by anticipating litigation's inevitable cost and collateral damage, and by transferring that risk to the insurance markets so that litigation, ideally, never takes hold.

TI can also mitigate professional liability risk, demonstrating executive due diligence by management, and advisory prudence by the outside legal, accounting, insurance and financial team.

TI is a category of risk transfer agreements designed specifically to facilitate mergers and acquisitions, divestitures, and other organic business transactions. Among the most common types of TI available are:

- Representations and Warranties Insurance
- Contingent Liability Insurance
- Litigation Buyout Insurance
- Tax Indemnity Liability Insurance
- Liquidating Trust and Trust Liability Insurance

- Liquidation Insurance
- Specialty Management Liability Insurance

Representations and Warranties Insurance (RWI) RWI provides coverage for the contractual indemnification obligations resulting from the breach of representations or warranties of the Seller. RWI can be purchased by the buyer or the seller. A seller-side policy can act to backstop the seller's indemnification exposure, shifting the risk to the insurer for a fixed cost. This risk transfer can enhance both the quality and scope of the indemnity cover, thus enhancing protection on both sides of the deal and facilitating its closure.

A buyer can also purchase RWI (or have it purchased by the seller). Examples of buyer-side covers include coverage beyond the survival period and/or cap under the purchase agreement; coverage where there would otherwise be no indemnification, as in a purchase of assets out of bankruptcy or a purchase of assets from a distressed seller; and, a cover intended to distinguish a bid in a competitive sale arena by reducing or even relieving the need for seller indemnity.

Of course, RWI is not exactly a panacea. Purchase price adjustments, known issues, intentional concealment and breaches of covenants will typically not be covered. Likewise, RWI will not extend to injunctive, equitable or non-monetary relief.

Contingent Liability Insurance (CLI) Unlike RWI, CLI covers known exposures or identified contingent liabilities. Examples include environmental clean-up costs, workers' compensation tail exposure, and other risks more or less certain in fact, but uncertain as to both timing and value.

Litigation Buyout Insurance (LBI) This form of TI can be an ideal solution when the seller is either unwilling or unable to retain the potential liability inherent in litigation involving the assets being sold. Where the buyer is likewise unwilling to assume such liabilities, LBI can be crafted to insure the exposure and thus clear the way for the transaction.

Tax Indemnity Insurance Potential tax contingencies arising from pending or threatened audits, availability of net operating losses in a change of control, debt cancellation issues, and reserves for uncertain tax positions under GAAP (FIN 48) are among the more common tax contingencies that can dog or even derail an M&A transaction. These common exposures are well-suited to being underwritten through TI, which can go considerably farther than a comfort letter toward keeping the peace.

> TI not only lessens the likelihood of M&A related litigation. It actually can prevent the seeds of discord from ever germinating.

Liquidating Trust and Trust Liability Insurance This solution has been developed to address the unique exposures facing liquidating trusts and their trustees. In addition, the tax qualification insurance section of these policies can protect trusts (and indirectly their beneficiaries) from the financial exposures resulting from a disqualification as a liquidating trust.

Liquidation Insurance This solution can facilitate an accelerated termination or liquidation of a private investment fund by providing insurance for either identified or unidentified contingent obligations that the fund managers believe must prudently be provided for by way of reserves or holdbacks.

Specialty Management Liability Insurance M&A activity often gives rise to D&O claims, especially if the deal were to fail outright, or if there was an alleged failure to disclose material facts, or other fiduciary breaches. In this context, TI helps to demonstrate the directors' and officers' due diligence and transparency, both on the part of the buyer and on the part of the seller, which may be seen to have a duty to undertake reverse due diligence. Specialty management liability insurance provides for specific liability exposures faced by boards of directors, management teams, fiduciaries, liquidators, trustees and transaction-related professionals in connection with a specific transaction or event.

Manuscript Policies It should come as no surprise that TI policies are carefully underwritten to meet the risk. This process takes time and considerable effort and energy, involving underwriters and other industry analysts, along with input from the would-be insured, well beyond a mere policy application form. Close coordination between the broker and client is essential. The underwriting process may involve an up-front due diligence fee.

TI Can Prevent Litigation As should be readily apparent, TI can function like a minesweeper in a harbor, locating and removing potentially explosive contingencies. With TI in place, parties can proceed with greater confidence, so that more deals close. And, when they do close, the investors, owners, and those who advise them are well-positioned to demonstrate their prudence and due care attendant to risk management within the deal. Overall, the ever-present threat of litigation surrounding M&A activity is, by virtue of TI, dialed way back.

Put another way, TI not only lessens the likelihood of M&A related litigation. It actually can prevent the seeds of discord from ever germinating. LM

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