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Marsh Specialty

Dual-track M&A process

Using insurance as a risk-mitigation tool

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Sellers often consider a dual-track process to optimize an exit.

In today's volatile and dynamic market, influenced by multiple variables — macroeconomic, geopolitical, market sentiment — sellers often look to a dual-track process to maximize and optimize exit conditions in M&A transactions. In a dual-track process, sellers seek exit terms through both a private M&A exit and an initial public offering (IPO), either concurrently or sequentially.

CONSIDERABLE RISKS AND EXPOSURES WITH EITHER SCENARIO FOR SELLERS, ADVISORS, DIRECTORS AND OTHER KEY STAKEHOLDERS

Offering securities to the public can create significant new risks for a company and its directors. Any offering will be scrutinized — first, by regulators, and later, by investors post-offering. This can result in claims being brought due to inaccuracies or omissions in the prospectus and may arise from regulatory, shareholder-related, counterparty and/or employee-related risks. The principal burden of liability usually rests with the issuer and its directors.

In a dual-track process, having covered the IPO-related risks through insurance, sellers need to consider how to mitigate risks if a private M&A scenario should materialize. In the current M&A climate, with highly volatile IPO conditions, a private M&A process might be considered the most advantageous exit route, and it could also be quite urgent. This leaves the seller with little time to direct the process and transfer the risk perspective to a private M&A exit setting. Depending on prevailing market conditions, a private M&A track may be deemed the most appropriate and effective exit solution at the outset, with the IPO as a backup alternative.

In a private M&A scenario, post-close contractual liabilities typically occur, regulated by the share purchase agreement (SPA) between the parties. A seller's SPA liabilities and adherent risk exposures, in the form of either warranties or specific indemnities, could attach at low levels of the purchase price, encompass large parts of the purchase price and for long time periods. Such liabilities thus constitute a major financial burden for the seller post-close, even if risks do not materialize.

To estimate the risks attached in either scenario, Marsh Specialty can review its claims data and cases for placed policies for either track — private M&A, insured through a warranty and indemnity (W&I) insurance policy, or, in the case of an IPO, a public offering of securities insurance (POSI) policy.

Marsh Specialty's data and case experience suggest considerable risks for key stakeholders for both exit routes

Marsh Specialty places thousands of W&I policies globally in any one year, and the data, as shown in Table 1, concludes that 10%–15% of the deals insured come with a claim notification. Although not all notifications would end up in an actual loss and claims payment, we can conclude that despite rigorous disclosure and due diligence processes, there are a significant number of deals with unknown and historic issues that could cause problems for the buyer or the seller depending on the commercial agreement between the parties — unless the transaction is adequately insured. Furthermore, when an actual loss occurs, it could become an issue requiring a multimillion-dollar remedy, as shown in Table 2.

Similarly, Marsh Specialty has advised clients and placed POSI on their behalf with significant negatively realized damages, including defense costs. Below is a case study on an actual US$30 million+ POSI claim.

CASE STUDY

A European retailer floated its online retail activity on Nasdaq. Soon after the IPO commenced, the share price decreased sharply, triggering a shareholders' security action against the directors of the company and against the company itself in the US. The claimant alleged that the information provided in the prospectus was misleading and false and omitted important details, which translated into allegations of misrepresentation and negligence and a breach of fiduciary duties. The claim was ultimately settled out of court three years after the first claim was made. The POSI insurers paid US$3 million in defense costs and US$28 million in indemnities to the claimants.

01| Percentage of transactions with a W&I claim notification, according to policy year[1]

(in %)

	2018	2019	2020	2021	2022	2023
North America	19	21	17	12	11	5
EMEA	10	9	9	8	7	5
Asia	9	18	9	8	5	1
Pacific	10	6	42	20	10	10
Global	14	15	14	10	9	5

02| Claimed losses (2022)[2]

(in %)

1| Policies closed in 2021–2023 will likely receive additional claims, and we expect the final percentages for those years to be higher.

2| These figures do not account for claim notifications where the loss amounts were unknown at the time of notification, which is common for third-party claims in litigation and tax audits, where the outcome is uncertain.

Bespoke requirements for dual-track processes

When considering a divestment, the seller and, in turn, the buyer can reduce private M&A risk exposures by using a W&I policy, while a POSI policy can help mitigate liabilities stemming from the prospectus, depending on the ultimate exit route. These policies are designed to protect the respective interests of the seller, the buyer, the public, management and the company. Using the relevant insurance solutions could be critical to transaction success and thus deal certainty. Therefore, these policies are essential tools in mitigating risk exposure by pricing and transferring risks to a third party — the insurance market — off the table of the seller and the buyer or the shareholders.

With a dual-track process, it's important to be prepared for either eventuality and exit route to then be able to safeguard the interests of the relevant stakeholders. For each exit route, it's usually in the parties' best interests to transfer relevant risks to a party outside the transaction perimeter, whereas both routes are unique and have their own specific risk profiles. Regarding the added uncertainty about who will ultimately own the target company — it's important to handle insurance needs with the required efficiency and care to deliver a bespoke solution for the stakeholders in either track.

Additionally, all companies will have a directors' and officers' (D&O) insurance policy in place, safeguarding the interests of the company's D&Os — most of whom will be subject to compulsory change-of-ownership termination clauses and potential IPO exclusions. Therefore, D&O insurance issues need to be addressed no matter which exit route the seller ends up choosing.

All options on the table for minimizing risk costs

Known risks are sometimes quantifiable or not material but sometimes come without a defined (perhaps significant) price tag. In an ideal state, buyer and seller evaluate and price risks that can be handled commercially between the transaction parties; for example, through price adjustments or, in the case of an IPO, with the new shareholders considered in the floating share price. However, with unknown risks — or known risks that are extensive or difficult to quantify — the gap between sellers and buyers could be too great for a deal to conclude. Therefore, the insurance industry, which is built upon pricing risks and adherent risk transfer, is a viable marketplace for handling these insecurities and providing stakeholders with a solution to enable the transaction.

ADDRESSING DEAL-SPECIFIC RISKS WITH THE RIGHT SOLUTION

POSI — A practical solution for IPO-related risks

A POSI policy, also known as prospectus liability insurance, offers bespoke coverage for liabilities arising from public M&A transactions and IPOs as well as bond offerings.

Depending on which financial marketplace a public offering is made on, the existing D&O can cover claims arising out of the offering if the issuing company is already public. This makes it possible to narrow the scope of coverage compared to a dedicated policy. Prior to its IPO, a private company would typically not have the appropriate coverage.

The offering can be covered either by extending the existing D&O coverage of the issuing company or with a POSI as a dedicated policy. Both methods have pros and cons, although the dedicated policy is usually preferable — and not just because its cover of transaction-specific risks is typically broader. It's also good risk management practice to ring-fence peak risk in a dedicated insurance vehicle to avoid ending up uninsured when it's time for the annual renewal.

A POSI is a project policy. It typically covers the liability of all parties involved in the offering, from the declaration supporting the offering (road shows, prospectus) to its execution. Among those with relevant insurable risks are:

- The controlling or selling shareholders and their D&Os
- The company issuing the securities and its D&Os
- The advisors of the transactions
- The investment banks involved in the placement
- Experts that may have provided valuation of specific assets for key elements of the offering

Such a policy covers both entities and people, thus providing comfort to all, and can help limit the need for a subrogation waiver of liability between the parties.

The duration of the coverage usually encompasses the legal timeframe of the liability; that is, six to 10 years, depending on jurisdiction.

The policy is fully dedicated to the transaction, and it cannot be canceled during the policy period once the premium is paid. The limit is proportional to the capital raised through the offering (usually around 20%).

The cost of this coverage can be attached to the transaction. This specific element of risk does not affect the regular D&O policy covering the issuing company for liabilities arising out of other aspects of the corporate life. A transaction policy also protects the regular D&O policy by ensuring that protection won't be impaired by any liabilities arising from the transaction.

As our clients most often prefer bespoke POSI coverage, Marsh Specialty uses a proprietary POSI wording based on years of experience, including actual claims scenarios. Marsh Specialty's position in the market, as the world's largest insurance broker, allows us to place our proprietary POSI wording with most of the relevant insurers and the leaders of this niche market. This is crucial for swiftly securing the required capacity while maximizing competition between insurers.

The structuring and placement of POSI policies occur simultaneously with other preparations leading up to the IPO. Beginning with the initial draft of the prospectus, the party to be insured can seek relevant terms from insurance markets. This process is concurrent with the underlying IPO process, including finalizing the prospectus and other agreements, such as the underwriting agreement between the seller, the company and the investment banks. All these processes continue in tandem until the entity is publicly traded, after which the insurance policy will stay in force until underlying exposure has expired.

The POSI insurance market is a very specialized one. However, relevant insurers are typically active in the broader D&O market, so there are correlations between insurance capital capacity, pricing, and available terms for POSI solutions and the market conditions for D&O policies. Notably, as with any specialized market, the POSI market is quite volatile because of its limited size and moving underlying factors, which include the general state of the financial lines' insurance market, prevailing macroeconomic factors, the current M&A environment and deal volumes, and particularly regulatory changes for IPOs.

Nevertheless, since 2022, the D&O market has become much more favorable to the insured than it was between 2019 and 2021, which were years of profit remediation on the insurers' side.

There is now greater competition among insurers that have returned to underwriting profitability. This leads to increased capacity and greater flexibility to extend policy language.

Although terms are similar in all major global regions, price and capacity vary greatly. As an example, we've seen large price decreases in the US and Australian markets — although these are decreases from high levels due to the frequency and severity of historic claims.

W&I insurance — Ensuring a clean exit solution for a seller

In private M&A transactions, it's customary for the seller to provide warranties to the buyer on a broad range of matters relating to the target, such as title to shares and property, employment, financial and tax, intellectual property, contracts, and other commercial matters. W&I insurance provides protection to either the seller or the buyer — typically, the buyer — against breaches of the warranties and indemnities provided by the seller in the SPA. Policies are bespoke and will be negotiated on a case-by-case basis.

The intention of the W&I policy is to cover:

- Unknown breaches of warranties/calls under the tax covenant
- Legal defense costs

W&I insurance is widely used across EMEA today and is an integral part of the toolbox for M&A professionals.

W&I insurance solutions are better equipped to handle low-frequency, high-quantum and long-tailed liabilities than other standalone alternatives. Financially, they are more effective than other means of security. In addition, these solutions actually transfer risks to a third party in the event of a warranty breach. Moreover, an insured solution can typically provide better warranty coverage for the buyer as the insurance market is more competitive than an individual seller could afford to be. Insurers can also provide for longer liability periods (24 to 36 months for business warranties, seven to 10 years for tax and fundamental warranties) and include a warranty cap chosen by the insured — again, most often, the buyer, depending on the buyer's risk appetite.

Effective premium cost compared to other security measures

The pricing of a W&I solution depends on several factors, but, currently, such a policy costs around 0.3%–1.5% of the insurance limit purchased. This represents a one-off premium for the entire policy period of up to 10 years.

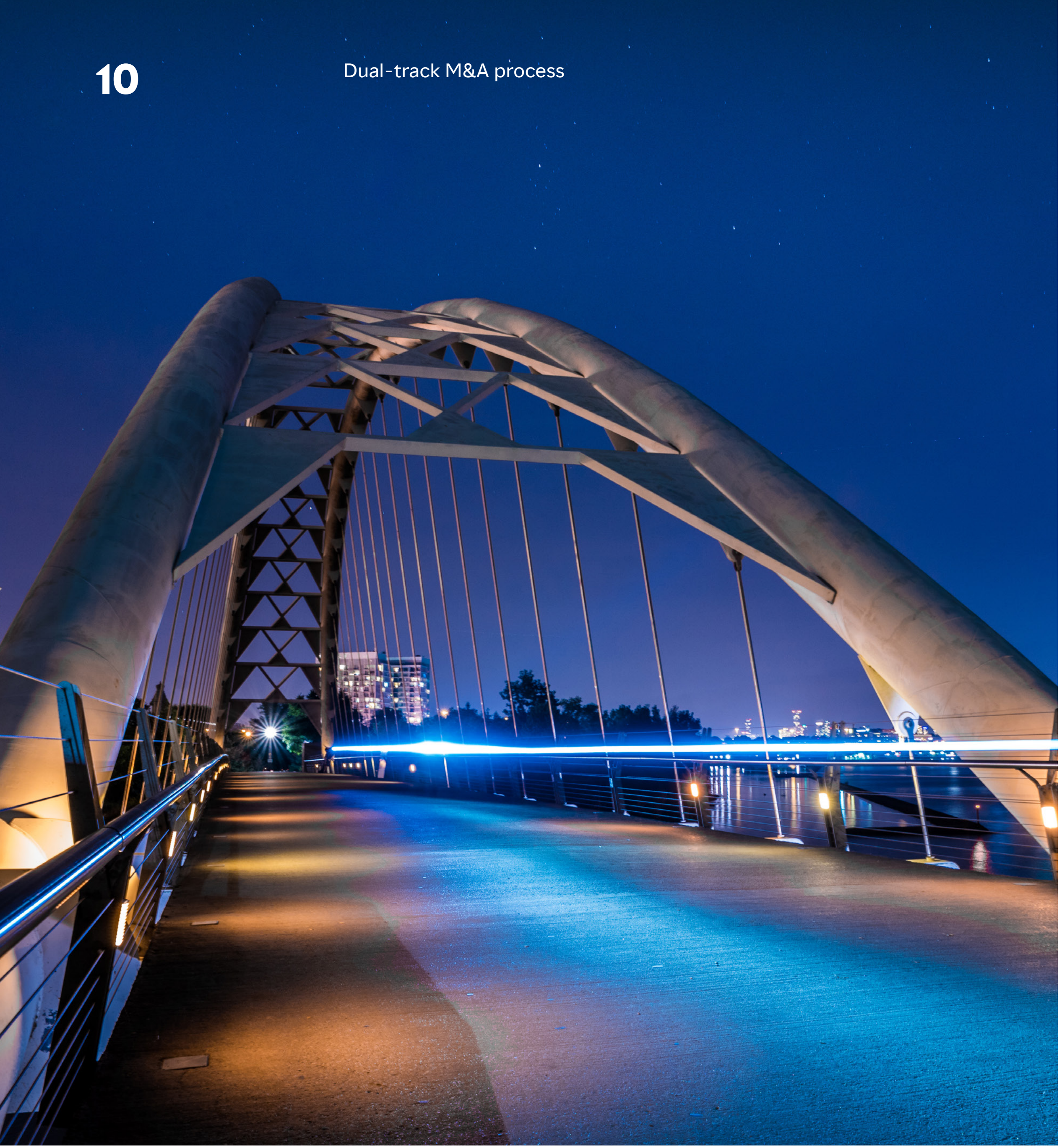
Matching the SPA's monetary thresholds

The policy includes an excess amount — a deductible to be met by the insured before the policy will respond (unless a different agreement has been specified in the SPA). The aggregate excess will generally represent 0.25% or 1.00% of the total value of the transaction and differs based on a variety of factors, such as transaction size, deal complexity, risk evaluation, industry and jurisdiction(s).

Increasing appetite for insuring contingent and tax risks in transactions

Parties sometimes face high-quantum but low- to medium-risk known issues in a transaction. Accounting for these could be cumbersome within the transaction's parameters — or they could even be deal breakers. Putting a price on the known issue and being able to transfer that risk to a third party may increase deal certainty. As the insurance industry prices, quantifies and accepts risk exposures for insureds, there is a growing appetite in the industry to also adjust for known M&A risks — in both private and public contexts. This, in turn, can enable sellers and buyers to transfer such risks to third parties for a commercially acceptable insurance premium.

Notably, contingent and tax risk insurance policies can also be used in an IPO context, where known risk exposures can be difficult or impossible to price and/or handle for the seller and the new shareholders.



MARSH SPECIALTY WORKS ALONGSIDE YOUR DUAL-TRACK PROCESS TO OPTIMIZE THE END RESULT

Understanding the operation and its underlying risks, working alongside the various parties, such as issuers, lawyers, banks, and advisors and knowing their constraints — and then navigating such a specific insurance market — is a job for specialists.

Marsh Specialty has the depth, experience and expertise to advise on the above-mentioned W&I, POSI, D&O, and contingent and tax-risk policies in multiple jurisdictions, and we have the reach to acquire the best solutions in every marketplace.

- Thanks to the trust of our clients, we have experience with hundreds of POSIs and thousands of D&O placements for companies making their initial public offerings. We are the market leader in insurable M&A risk mitigation in most of the large financial marketplaces.
- Marsh Specialty is also the leader in placing W&I policies. In EMEA alone, Marsh Specialty has placed nearly 2,000 W&I policies over the past few years, ensuring that the process for structuring, negotiating and ultimately placing a W&I policy runs smoothly alongside the underlying divestment or acquisition.

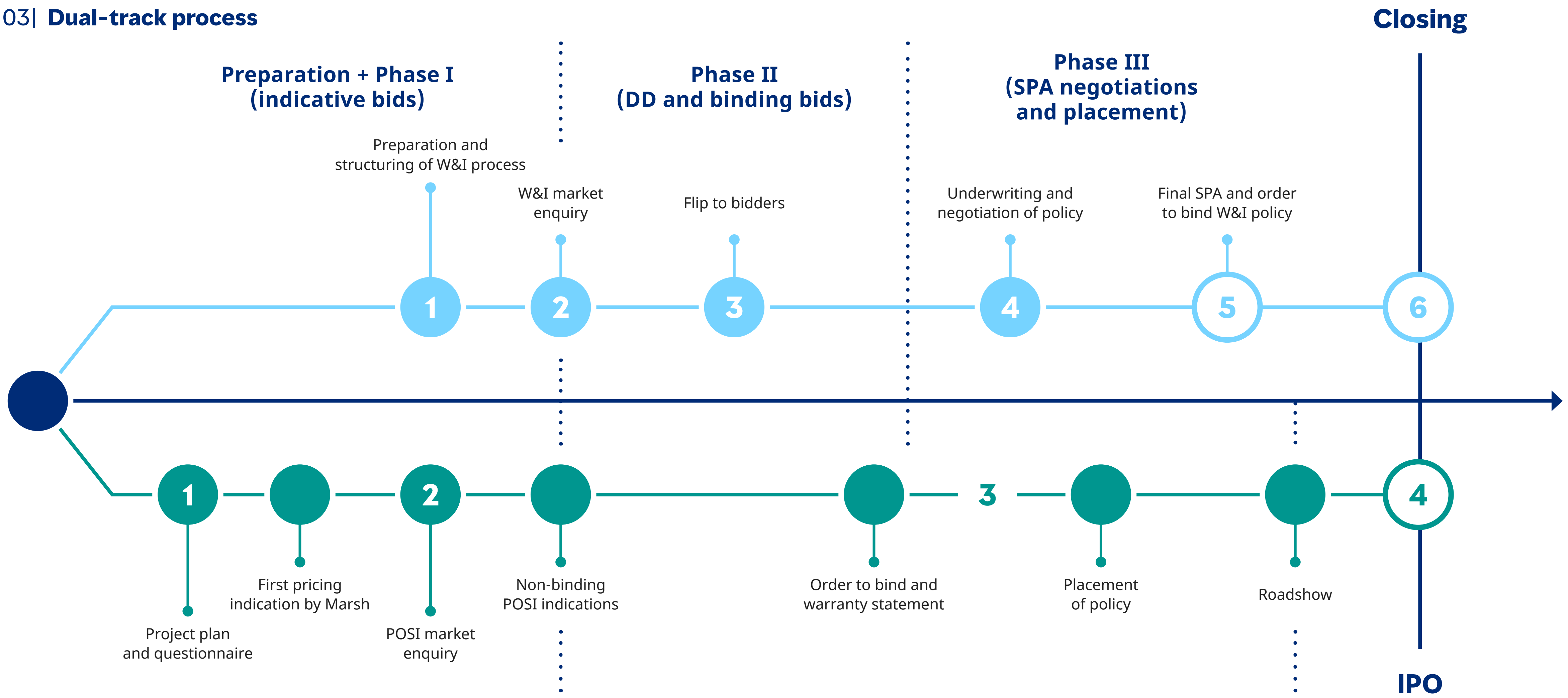
Placing the appropriate transaction coverage is quite complex. But that's not where it ends. In insurance, the product is the claim. Our dedicated claims advocates have collectively assisted in the resolution of billions of dollars in claims related to these policies.

Our experience makes the difference when it really matters.

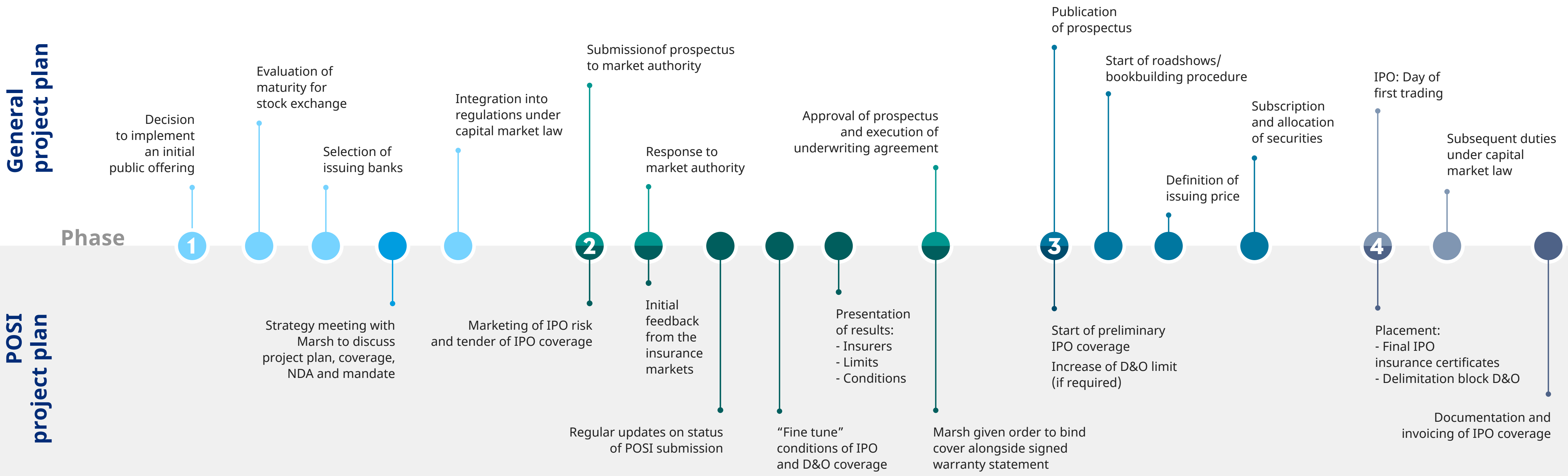
Marsh can work seamlessly with the transactional parties, advisors and other stakeholders to ensure that relevant and insurable transaction-related risks are covered — one team working together across the dual tracks:

- A single point of contact assists the client across all relevant insurance and risk management work streams.
- There is no duplication of work as there is data and information overlap between the two exit routes due to the single point of contact.
- We use insurance market overlap between POSI and W&I to gain additional leverage to negotiate and structure the two programs.

03| Dual-track process



04| IPO process plan



Marsh continues negotiating with insurers as the project progresses, aiming at an optimal offer.

05| Illustrative W&I insurance process

1 Transaction preparation | 2 First bidding round | 3 Second bidding round | 4 Final phase | 5 Signing | 6 Closing

Connect with Marsh

What?
- Kick-off call with Marsh
- Sell-side work free of charge

Why?
- Smooth process
- Better coverage (e.g., re locked-box accounts)
- Full competition among W&I insurers
- Bidders don't conflict with insurers

When?
- Prior to NDA made available to bidders

Inform bidders update transaction docs

Why?
- Process documents to reflect W&I process
- Transparency prevents bidders from rigging the process

What?
- NDA, process letters and SPA

Sell-side market inquiry

What?
- Non-binding indications (NBIs) from W&I insurers Marsh NBI report

Why?
- Full insight for seller of coverage and insurance costs

What is needed?
- SPA, IM and EV range

When?
- **Soft-stapling** usually one week, **hard-stapling** usually two weeks prior to SPA being shared with bidders

Soft-stapling or hard-stapling (pre-underwriting)

Soft-stapling

What?
- NBI report shared with bidders
- Sell-side work ends here

When?
- Together with SPA being shared with bidders

hard-stapling (pre-underwriting)

What?
- Sell-side DD/FB underwriting
- Marsh negotiates a policy with most suitable insurer
- Bidders receive full W&I package (balanced SPA, W&I policy, DD guidance)

Why?
- Front-loading of work
- Faster signing process
- More control for seller

When?
- One week prior to SPA being shared with bidders

Allocation of trees and process control

What?
- Allocation of clean Marsh trees to bidders ("flip")
- Marsh sell-side team ensures process control and full competition among W&I insurers

Bidders continue process

What?
- Buy-side underwriting with Marsh tree and W&I insurer

When?
- Hard-stapling usually 2-4 days, soft-stapling usually 7-10 days prior to SPA signing
- The W&I process can also be finalized shortly after SPA signing

Buyer signs W&I policy

Buyer pays premium and policy inception

When to use hard-stapling?

- Attractive target and deal value ca. €100m+
- Highly competitve & fast process
- Sell side material available (at least legal factbook)
- Auction draft SPA already contains balanced warranties

... IF NOT ... use Soft-stapling

Meet the team

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