

MERGERS & ACQUISITIONS

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Transactional Insurance Protecting Venture Capital, Private Equity and Family Owned Business Sellers in the Current Buyer's Market

Encouraging signs of stabilization in the global economy and the capital markets suggest that 2010 may bring a broad uptick in mergers and acquisitions activity. The Mergers & Acquisitions (M&A) landscape, once dominated by private equity sponsors able to utilize easy leverage to engage in ultra-competitive auctions, has shifted and the focus is now on strategic buyers. With strong balance sheets and large cash war chests, strategic players are using all-cash bids fueled by strong pricing multiples to dictate terms to venture capital, private equity and family owned business owners that are seeking an exit after suffering through the turbulence of the last two years. The current buyer's market is rooted in a number of causes: first, the global drag on the economy over the prior several years has resulted in depressed asset valuations, encouraging buyers to seek favorable pricing on valuable assets; second, sellers' financing options remain limited and the debt and capital markets are just beginning to recover, causing some investors to seek M&A exits rather than undertaking refinancings or recapitalizations; third, the two-plus year decline in M&A activity has created a sizeable backlog of privately held and institutionally owned companies, leading to mounting investor pressure for prompt liquidity events and distributions.

Not surprisingly, buyers have seized upon their newfound negotiating leverage to force sellers to make material concessions on deals. Sellers are increasingly willing to accept deferred purchase price mechanisms such as earnouts, holdbacks and larger escrows with longer hold periods, as well as more onerous indemnification terms such as smaller deductibles and larger caps, longer survival periods and significantly tougher representations and warranties.

Representations and Warranties Insurance ("R&W Insurance") is a valuable tool for sellers navigating this buyer's market to both mitigate and manage increased transactional risk exposures. R&W Insurance protects a party from financial losses resulting from an inaccuracy in the representations and warranties made by a seller about a target company or business in connection with a merger, acquisition or divestiture. In the current market, Chartis' Mergers & Acquisitions Insurance Group is witnessing an increasing demand from sellers seeking R&W Insurance as a means to:

- (i) mitigate heavy post-closing indemnification burdens emanating from the buyers' current negotiating strength;
- (ii) allow financial sellers (i.e., private equity and venture capital funds) to exit investments cleanly with limited long-term liability;
- (iii) allow owners of family-owned businesses and distressed sellers to exit a transaction and distribute purchase price proceeds with lessened concerns about long-term indemnity obligations; and
- (iv) provide comfort to buyers purchasing businesses from distressed sellers or retiring family owners, ensuring they will have a liquid source of indemnification should a breach of representation claim arise post-closing.

By way of example, here are two recent instances in which Chartis' R&W Insurance helped sellers consummate transactions in the face of extensive indemnification obligations.

- An international financial sponsor agreed to sell one of its portfolio companies, a U.S. manufacturer, to a large strategic buyer. As a foreign investor, the financial sponsor was barred from being too involved in the day-to-day operations of the portfolio company due to the sensitive industry in which the manufacturer operated. Understandably, the foreign seller was quite concerned about unknown breaches of representations and warranties by the portfolio company given its inability to be involved in the day-to-day operations of the target, particularly when combined with the full joint and several liability of all sellers that the strategic buyer was able to negotiate. Furthermore, the strategic buyer also demanded that all sellers agree to a large holdback, against which the buyer could offset any future indemnity amounts. Not surprisingly, the financial sponsor balked at buyer's tough terms and sought to lock in the returns to its limited partners. The financial sponsor purchased Seller-Side R&W Insurance product to protect its interest in the holdback amount against unknown breaches of representations, and ultimately to facilitate the distribution of the sale proceeds to the fund's limited partners.
- The shareholders of a software company, including several venture capital (VC) investors whose funds were on the verge of winding up, agreed to sell their company to a large strategic buyer. Given the sellers' limited negotiating leverage in the current market, the buyer was able to extract more burdensome representations and warranties and a larger indemnity and holdback than the sellers had anticipated. The sellers, led by the VC investors, sought an additional buffer against those burdensome deal terms, as well as added protection for the distribution of sale proceeds to their investors. The solution for the selling shareholders was the purchase of a Seller-Side R&W Insurance policy that would protect them against potential liabilities for breaches of representations and warranties.

R&W Insurance is a useful tool that can facilitate transactions and transfer transactional risk to the insurance markets. As the above examples illustrate, R&W Insurance is particularly useful in the current economic environment to help level the playing field for sellers looking to make a clean exit, insure against tough deal terms and protect their sale proceeds in this buyer's market.

To learn more about transactional insurance products, please visit our website, www.chartisinsurance.com, send us an e-mail at MAInsurance@chartisinsurance.com, or contact your insurance broker.

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