

PUBLIC R&W DEAL INSURANCE ON RISE: AON

Over the past several years, the growth of Representations & Warranties insurance in middle market M&A deals has been staggering. Are public deals next?

BY ERIC ZIFF

Over the past several years, the growth of Representations & Warranties (R&W) insurance in middle market mergers and acquisitions deals has been staggering. Aon, for example, placed over 400 R&W insurance policies last year in North America, compared to less than 80 only five years ago. The use of these policies has become entrenched across a wide spectrum of deal sizes and industries. While many know of the benefits of R&W insurance—increased proceeds to sellers at closing, more efficient negotiation of contentious deal points, buyer recourse against a credit-worthy insurer, and so on—it's hard not to feel a key value proposition has been overlooked. The overwhelming majority of R&W policies have been placed on acquisitions of private companies, yet the product offers significant benefits for public company deals, too.

Buyer-side R&W Insurance policies serve either to bolster a limited indemnity given by a seller or replace that indemnity entirely, in which case the buyer's sole recourse would be to the policy. This latter structure is commonly referred to as a "public-style deal," because the purchase and sale agreement typically will be analogous to a public company deal. James C. Freund's seminal M&A book "Anatomy of a Merger" outlines the difference between post-closing protection in private M&A deals and public M&A deals:

"Generally speaking, there is no indemnification section in acquisition agreements between two public companies, inasmuch as the agreement usually states that the respective representations and warranties terminate upon the closing."

When "Anatomy of a Merger" was written in 1975, this was very much the case. Shareholders were then, as they are now, loath to stand behind the representations and warranties of a company they owned in only the most passive sense. However, in the same way private company acquirers routinely capitalize on R&W insurance to receive protections they had



historically sought from a seller, public company acquirers can now avail themselves of these same protections.

Aon has observed financial sponsor clients using this approach more and more in the context of "take-private" transactions. But despite the obvious logic of this approach, too many strategic and financial buyers still subscribe to the traditional paradigm that no protection in public deals is available. Contrary to the popular view that public deals are less risky than their private counterparts, one salient example shows that public deals can still pose similar threats to acquirers.

In October 2011, Hewlett-Packard (HP) acquired Autonomy for \$11.7 billion. After the transaction closed, HP discovered accounting irregularities and believed Autonomy had defrauded them, resulting in a write-down of 85% of the acquisition value, a loss of approximately \$8.8 billion. Following the announcement of the write-down, HP was subjected to numerous

shareholder derivative suits, some of which alleged that HP had been negligent in its due diligence.

This example, though extreme, illustrates that an acquisition is not inherently de-risked because the target company is publicly traded, large in size and subjected to seemingly robust audits. HP suffered tremendous setbacks, both in terms of the diminution in value of their investment and payouts on derivative suits, not to mention the devaluation of HP's stock and reputation. These are exactly the types of situations that indemnities have historically been used to remedy, and why buyers have purchased R&W insurance on private company transactions.

This same approach can and should be used to provide cover on public company acquisitions. And while most transactions will turn out not to have the challenges that Autonomy posed for HP, R&W insurance can (and does) respond to items far less material that can still represent meaningful financial damages for a buyer. R&W Insurance is there to protect against inadequate disclosure and to safeguard buyers from items that are not spotted in a robust diligence process. The issues discovered by HP at Autonomy are no different than those that have been the basis for many claims under R&W policies.

It was not long ago that members of Aon's Transaction Liability team would walk into rooms full of lawyers and other deal professionals and be met with little to no interest in R&W insurance. Those days have long since passed, and the deal efficiencies that have been realized through the use of R&W insurance have forever changed the way private M&A deals are done.

It is only a matter of time before such realizations permeate the public M&A market. Shareholders of public acquirers should expect their fiduciaries to procure reasonable protection against a deal going awry, if such coverage is obtainable.

A few years ago, a private equity attorney remarked that the failure to bring up the availability of this insurance to private M&A clients was borderline malpractice. While we have not reached that point on public M&A transactions, it seems like a conversation worth having. Nobody goes into a transaction expecting to buy the next Autonomy. But nobody can predict the future, either; that's why people buy insurance.

—Eric Ziff is a managing director in Aon's Transaction Solutions Group.

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