HWF
PARTNERS

Are PE eyeing up P2Ps? Can insurance play a role?

by Rowley Higgs

Public to Private transactions ("P2Ps") are still in the minority in the private equity community and are not frequently seen in the insurance market. However, the past few years have seen an increase in the number of take-privates generally and we have received more enquiries and have placed policies in relation to these deals. With the market capitalisation of many listed companies having reduced significantly in recent times some have speculated whether we might see a further uptick.

Why is insurance relevant?

Traditionally, a takeover affords less protection to a buyer than a private M&A deal, as there is less scope for warranty protection and price adjustment mechanics. Consequently, PE funds have sometimes looked to insurance to try to safeguard themselves against unforeseen/undisclosed liabilities. We have sourced such protection for a number of transactions in other European and Non-European jurisdictions, although not yet for a UK public takeover. Advisers of listed companies would flag that the disclosure requirements imposed on their clients from a regulatory perspective should provide sufficient visibility, but PE houses are increasingly keen to explore whether there might be an additional layer of protection available.

The first question to address is whether it is possible to insure such transactions. The short answer is yes. The more interesting questions are: how is this achieved and is it worth it? We analyse below the issues which a purchaser faces when seeking insurance for a P2P in the UK and how best to overcome them.

It is worth noting that the rules governing public takeovers differ for each jurisdiction, so the process on any deal will need to be considered in light of the relevant legal framework, but (as many jurisdictions have less stringent requirements than the UK) the below covers most of the issues that are likely to be encountered in any jurisdiction.

Insurance requirements

In a nutshell, to get warranty and indemnity ("W&I") insurance you need a party: i) willing and able to give warranties (or you need a synthetic warranty structure); ii) able to carry out a robust disclosure or Q&A process against those warranties; and iii) able to conduct thorough due diligence into the subject matter of each of the warranties.

Secrecy and the *Rule of Six*

Before assessing the practical issues posed by the above requirements for W&I, we need to consider whether it is possible to introduce insurance into a takeover process and adhere to confidentiality requirements. The Takeover Code (the "Code") imposes strict secrecy obligations on bidders to ensure that the existence of a possible offer is not leaked. The consequences of breaching these obligations are that the offeror may be forced to announce its interest in a target before it is fully prepared to do so, which may result in the offer being abandoned or otherwise unsuccessful (and considerable time/expense being wasted).

Practice Statement 20 of the Code explains that the offeror must speak to the Panel if it wants to approach more than six external parties in connection with a potential offer (which includes: providers of finance (equity or debt), shareholders in the offeror or the offeree, pension fund trustees, potential management team candidates, significant customers of, or suppliers to, the offeree). As an advisor to the offeror, the insurance broker is unlikely to be counted, but insurers would likely be external parties.

Normally we would approach many insurers to increase competitive tension, but to retain secrecy HWF has the experience to approach only a very select few markets based on our analysis of the specific transaction/sector. That said, we understand that many bidders are fearful of leaks when approaching third parties (including multiple financing banks), and are aware that the

idea of approaching even a limited number of insurers may be deemed too significant a risk to allow for an insurance solution to be sourced prior to the offer being announced. In such circumstances it should be noted that insurance can be put in place following successful completion of the P2P.

Warrantors and warranties - Rules 16.2 and 21.2 of the Code

Rule 16.2, which deals with management incentivisation, provides that arrangements between an offeror and offeree management will require: i) a fairness opinion; and ii) to the extent that management are shareholders of the offeree company and are receiving shares in the offeror by virtue of the takeover in a manner not being extended to all shareholders, approval from the independent shareholders of the offeree company. This approval process requires disclosure of the PE fund's proposed arrangements with the management team to a potentially wide audience, which some funds often want to avoid.

Under Rule 21.2 of the Code, an additional question arises as to whether the giving of warranties by offeree management would be deemed to be a (prohibited) offer-related arrangement, which includes an inducement or commitment in relation to the transaction. To the extent that the management team giving the warranties are directors of the offeree, they would prima facie be caught by the Rule as concert parties of the offeree, whereas if management were not target board directors, the Rule may not apply. In any event, the Rule may not apply where liability under the warranties is subject to a nominal £1 cap, as the Panel may not consider this to qualify as an offer related arrangement by virtue of being de minimis and, in practice, an extension of the diligence exercise that may otherwise be being carried out.

Therefore, in addition to secrecy, there are certain other factors to consider if seeking to put insurance in place prior to completing the takeover. These hurdles would be removed if the insurance were to be put in place following completion of the transaction. Assuming the PE fund is happy to disclose details of their equity arrangements, it appears that, in principle, management can give warranties without falling foul of the rules of the Code. So far so good; we may have a group willing and able to give warranties.

Disclosure, Diligence and Rule 21.3 of the Code

Disclosure and diligence are the next hurdles to overcome. For private M&A the buyer conducts a thorough diligence exercise to satisfy itself of the legal and financial position of the target company, and there is likely to be limited information available to the purchaser unless the seller agrees to disclose it. By contrast publicly listed companies are compelled to continuously disclose information to the market. Subject to limited exceptions, the Market Abuse Regulation requires the immediate disclosure by listed companies of information, which (in broad terms) is likely to have a significant effect on their share price. Consequently, it may be suggested that there should be little or no additional information (at least of a material nature) which a potential purchaser should need to receive.

However, flipping that argument on its head, on the basis that all "inside" information should have been made public, the target should (subject to customary confidentiality restrictions being put in place) be in a position to disclose other information, which is not price sensitive, in much the same manner as on a private M&A transaction. Indeed, it is common practice for the target to disclose information to the offeror via a Virtual Data Room ("VDR"). The difference between this VDR and the VDR for a private deal is going to be the way it is populated and what it contains. In a public company context, the information which is normally provided to an offeror is information which the target board think the offeror needs to understand the business and which addresses specific issues likely to arise on a change of control, rather than information which discloses issues against a suite of warranties. The information that is disclosed on public deals is therefore often described as being 'confirmatory' in nature. Also, because of the secrecy obligations, the VDR is frequently pulled together more quickly by a limited number of individuals who may not have visibility to any level of granularity. This is particularly the case in offers for multi-national companies. Disclosure may also be limited by competition and data protection regulation in the usual way. All that said, it is still possible for the offeree to provide the requisite information for disclosure against a suite of warranties and therefore for a buyer to carry out the diligence required by the W&I insurers.

Perhaps the key consideration with regard to the scope of disclosure is rule 21.3 of the Code which provides for equality of information for a competing offeror. Generally speaking, a PE fund will need much more comprehensive DD as compared to a corporate / strategic buyer who may be more comfortable with the risks as it already has significant operations in the same industry as the target. As a result, the PE buyer will be seeking the broadest possible disclosure via the VDR. This is relevant because the obligation to treat bidders fairly could result in the target having to grant access to the VDR to another potential bidder (possibly a competitor) thus requiring the disclosure of information which is potentially commercially sensitive. As both the PE fund and the target would want to avoid this scenario arising, it may be difficult to carry out the disclosure exercise required to satisfy the insurer's DD requirements.

Are synthetic warranties the answer?

An alternative, if the offeror does not want to enter into management incentivisation discussions prior to launching their offer or management are otherwise unwilling to provide a set of warranties (albeit with a £1 cap), is to take out synthetic cover whereby the insurer offers warranties under the insurance policy. It should be noted that the insurer will still require disclosure against these warranties (via a VDR) and diligence to be undertaken in relation to their subject matter, so many of the considerations already examined would still apply (Secrecy and the risk of a leak; Disclosure limitations or requirement to disclose to other bidders).

Insurers will look to obtain comfort in relation to the quality of the disclosure process undertaken by: (i) feeding into the questionnaire submitted for the population of the VDR and any other information gathering through due diligence requests, and (ii) adding to the Q&A process in order to try to drive quasi-disclosure. It should be noted that whether the deal is public or private, where the disclosure is not likely to be fulsome due to the seller not actually giving the warranties, the warranty package offered by insurers is often narrower (sometimes limited to the extent that it comprises only warranties against which generally no disclosure would be required, e.g. accounts warranties on the basis of audited accounts).

We are in discussions with insurers as to whether it might be possible to create of a standard set of warranties, which they would be happy to cover regardless of the underlying asset. We would provide expectations as to minimum disclosure requirements to obtain cover for these warranties. This could potentially avoid the need for multiple insurers to be approached or could provide interim protection on the basis of limited disclosure, which could be enhanced pending a broader disclosure exercise being carried out following completion of the takeover.

Insurer Appetite

From our discussions with insurers there is clearly a desire to assist the PE community in relation to P2Ps, but there is relatively limited experience of underwriting such transactions. As a result, underwriting fees are likely to be higher (at least initially), as insurers try to accommodate innovative structures, and the process will require more time than for private M&A. From a pricing perspective, our conversations on this topic have been very interesting with some taking a far more conservative approach and others recognising the reduced risks associated with companies that are subject to considerable regulation/disclosure requirements. Pricing will be very dependent on the specifics of the deal (the following factors will all be considered: on which stock exchange the target is listed, the sector, the size, the jurisdiction, whether with management warrantors or synthetic warranties). The increase versus a private M&A deal might be: i) as little as 10% where: the sector is perceived to be simpler; management are giving the warranties and are able to carry out a more fulsome disclosure exercise; or ii) as much as 100% if the sector is considered more complex and the purchaser is seeking synthetic cover. In our view, where insurance is a viable option, we would expect the increase to be no more than 40%. Retention and de minimis requirements will be higher than for private M&A deals as a result of the higher-level approach likely to have to be applied to the disclosure process.

Worth it?

The reality is that the cost of any protection is likely to be more than a standard policy on a private deal and the coverage (scope of warranties) may be narrower. However, like any warranty protection there are two obvious advantages to taking out the policy. The first is that you may be able to force better disclosure, and the second is that you have recourse in the unlikely event of a loss. The risk of that loss arising may be remote but certain high-profile takeover failures, such as the acquisition of Autonomy by Hewlett-Packard, and Bayer's 2016 takeover of Monsanto, suggest that even trade buyers could benefit from additional protection. It is also worth considering that AIG reported in their most recent study that claims frequency remains highest for the largest, most complex deals. Claims notifications were received on 26% of their M&A deals with a value between USD$500 million to USD$1 billion and 23% of the deals with a value north of USD$1 billion. As with W&I generally, our view is that the biggest driver for insurance is bridging the gap between the buyer's need for protection and the sellers' usual or desired recourse structure. The division between ownership and control means that there is generally no recourse or very limited recourse offered by sellers of listed companies. As with any private equity structure, although the management may be well placed to give the warranties, it might be pointless/counterproductive to bring the claim against them as they may not have the ability to pay (their wealth likely being insufficient or tied up in the target business) and the claim would likely disincentivise them. Therefore, our view is that W&I can play a useful role in allowing P2Ps to be concluded with all parties transacting on a basis with which they are comfortable. For the reasons set out above, we acknowledge that it may be preferable to arrange the W&I policy as soon as possible after completing the takeover rather than trying to put in place at the same time as running that process. However, the timing should be considered in light of the rules governing the process in the relevant jurisdiction, as some of the issues identified in this article are not applicable in other countries.

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