PARTNERS

M&A insurance and the fund secondaries market

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With the Covid-19 virus spreading around the world and creating unprecedented disruption across the financial markets, the volume of M&A, like much of the rest of the economy, has boomed in some areas and stuttered or come to a halt in others. In the case of the secondaries market, the denominator effect will continue to lead to LP's exiting and GP's rolling investments, while other investors may face significant liquidity issues forcing sales. When the market truly starts to recover, given the large amount of dry powder the secondaries players have ready for deployment, we are expecting an increased number of these transactions and a wave of new opportunities for investors. With this increase, together with traditional corporate law firms having built funds teams, some of the protections that might be seen on a standard corporate/private equity ("PE") deal are being explored by secondaries players as innovative ways to protect themselves from price uncertainty and prepare for the future.

The M&A insurance market has been evolving for some time to insure transactions outside its traditional playing field of mid-market PE deals. The Covid-19 downturn has further accelerated that evolution with insurers responding to the exploration of principals and advisors in alternatives to mitigating risks in their transactions. As a result, while over the years HWF have worked on a number of secondaries, only a handful of insurers had appetite for such deals. This is now changing at a perfect time for the growth in certain parts of the secondaries market with insurer appetite emerging for the more complex secondaries transactions. There are now a number of insurers who have the requisite knowledge and understanding of these types of structures to provide insurance solutions. HWF's extensive experience allows us to advise clients on the best approach and strategy to be followed, which includes recommending an insurer who will provide the best possible solution. This article provides some guidance on the key areas to consider for GPs and funds (as well as those advising them) when undertaking secondaries.

The Current situation

GP-LED SECONDARIES – With PE not hitting valuations on assets, we have seen an uptick in GP-led secondaries where houses are recycling assets. We expect this trend to continue to dominate the secondary market for the foreseeable future. There are a number of reasons GP-led transactions will continue to thrive:

- **Fund lifespan –** As funds life draws to a close GP-led secondaries can provide valuable time for managers (and some LPs if they chose) to earn more money from an asset that they consider will result in a considerably larger return down the line.
- **Liquidity –** GPs are facing short-term liquidity needs to due the pandemic and are looking for solutions, such as realising some of the value of a particular investment by rolling part of its interest and selling out a stake to a minority investor.
- **Confidence –** As mentioned, the secondary market has grown considerably over recent years and GPs consider the secondaries market as a key component for portfolio management.

In the GP-led secondaries market, the use of W&I insurance is now commonplace and these transactions have insured GPs for many years. This is because GP-led transactions have many similar transaction hallmarks to PE single asset secondary buy-outs.

Dealing with conflict is key

One key distinction to be drawn between a GP-led secondary (and in many cases also fund secondaries) and a traditional PE exit is that the former are inherently conflicted transactions with significant rollover of interests from sell-side to buy-side. This is particularly obvious where a GP transfers assets out of one fund directly into a new fund managed by themselves. This conflict of interest when it comes to warranty protection needs to be carefully considered under a W&I policy:

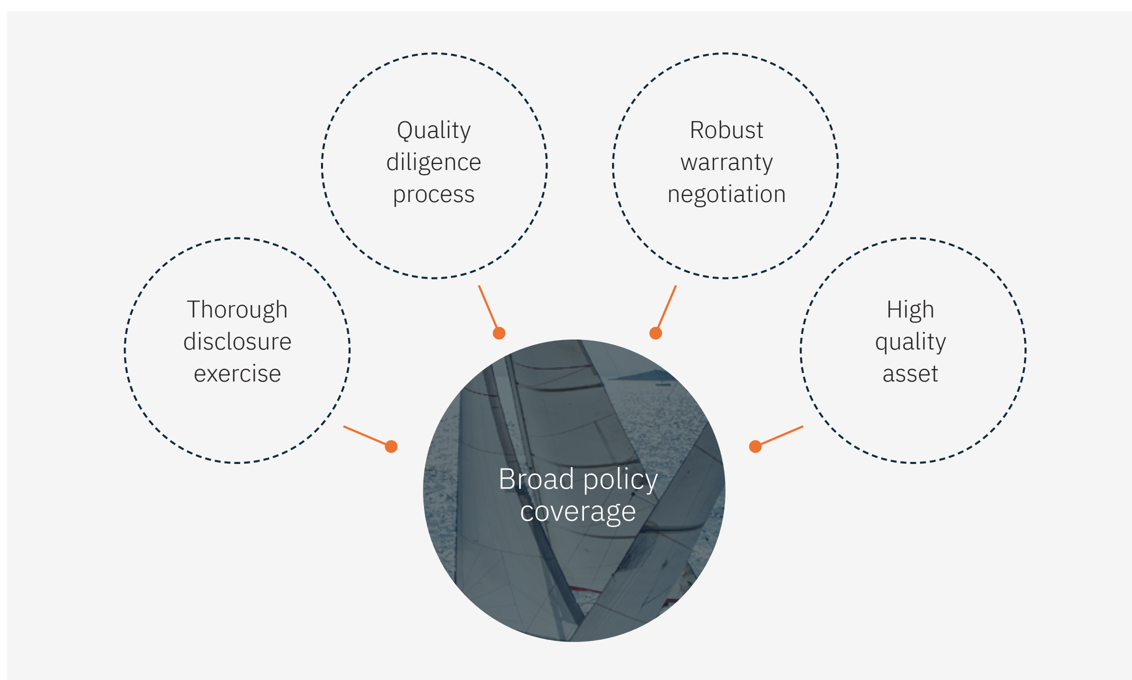
- Clean teams on the sell-side and buy-side must be demonstrated for diligence and disclosure purposes.
- Knowledge of the sell-side being imputed to the buy-side is fatal for the insurance because any items that the buyer's deal team has "actual knowledge" of is expressly carved out from cover under the policy. It is therefore key to make sure the correct knowledge pool is captured with no contamination of information from one side to the other. If there are any rollover sellers or minority investors coming in, consideration needs to be given at the outset to how knowledge and any information requirements can affect the process, and to the various parties' ability to make a claim under the policy. As above it is key to make sure that knowledge of one is not unfairly imputed on all.
- While seeking to protect the interests of both sides from knowledge contamination, equally the insured parties need to be comfortable that all material information has been disclosed to insurers, and crucially that they are aware of the content of such information – they will be required to represent this fact in a No Claims Declaration or Representation Letter. To further mitigate the risk of insurers arguing that cover is limited due to contamination of knowledge, this sometimes needs careful drafting in the policy to limit certain interested parties' knowledge or understanding of due diligence ("DD") only to those areas of their expertise or review.

FUND SECONDARIES – Whilst we have seen a number of transactions where majority and minority stakes of entire funds are acquired these have been far fewer in number, and it is expected that these types of transaction will face significant challenges in the short term, particularly given the uncertainty of pricing of fund interests which is typically based on historic pre-signing net asset values, none of which reflect the current market volatility.

Use of insurance on fund secondaries has been rarer and more recent. We have seen a number of W&I policies placed over the last 18 months and it is certainly becoming more commonplace. One of the drivers is a trend towards removing "my watch your watch" provisions from sale agreements – something which we believe has come across as a result of PE lawyers widening their practices. The removal of such indemnities would offer the exiting investor a completely clean exit provided that the incoming investor can feel sufficiently protected. This has led to demands from incoming investors to have a wider set of warranties than the traditional handful of title warranties together with a "my watch your watch" indemnity. Having an effective tool through insurance to bridge the gap in expectations on recourse between incoming investors and the exiting LPs has been welcomed in the market, providing incoming investors with greater warranty protection, and allowing exiting investors to limit their liability and free up the proceeds.

Differing approach to Diligence

Whereas based on our experience the DD in GP-led secondaries mirrors that of the primary investment, the processes and DD involved in fund secondaries has been an area of great education in the insurance market. Potential secondaries buyers will need to carry out DD on the fund of which the interests are being sold. As with your typical M&A / W&I process, the key for insurers providing broad cover is for a fulsome DD scope which covers the breadth of the warranties, the warranties being given must be relevant to the transaction and a fulsome disclosure exercise by the sell-side is required, in all cases carried out in the same manner as it would be absent insurance.



We often see DD on these types of transactions focussed on the transferability of any side letter benefits the selling investor has with the fund's GP/manager and the ownership/ investment structure of the fund (particularly whether any interests are held in alternative investment vehicles), which usually provides sufficient information for the fundamental warranties to be covered. In terms of affording cover for financial and tax warranties, insurers usually request to see investment committee papers and will go through a detailed Q&A process with the incoming investor during underwriting to ensure the relevant work has been done – even if not memorialised in formal DD reports.

It should be noted that if the warranties given are knowledge qualified and a light touch DD exercise has been carried out (i.e. by simply asking management for confirmations) then that is where the insurers will come into issues and cover may be limited.

Creating Value

The fastest area of growth within the M&A insurance market is the provision of risk specific policies covering known or contingent risks. These are often issues which absent a solution will hit to asset or fund valuation and therefore purchase price as well as residual liability. Insurance has become a neat and cost-effective tool across the M&A marketplace to deal with these obstacles. Given the breadth of expertise within the market, these issues span a wide variety of underlying areas, most commonly - tax, (re)structuring issues, litigation, regulatory issues, commercial disputes, pensions and environmental concerns.

Cover can be sought with a summary of the matter from professional advisors along with an idea of the possible quantum. This will allow the insurer to attempt to validate the probability of loss arising from it and comment on whether it is insurable.

Given the issues faced in closing fund secondaries mentioned above, in the current climate we have had increasing enquiries for contingent policies to deal with balance sheet risks in portfolio companies that go to value in order to provide funds with the opportunity to execute secondaries successfully with more accurate and robust valuations for incoming investors. Equally on GP-led deals, contingent policies are essential to making sure that the new fund is able to take on assets that are not pregnant with contingent liabilities, while ensuring that the fund being closed is able to liquidate and distribute funds to LPs quickly and efficiently.

In Conclusion

As detailed above, whilst there has been a downturn in the activity, it is clear that there will be an increase in secondaries transactions and the M&A insurance market can offer solutions to de-risk transactions and mitigate historic issues that incoming investors may face. Secondaries deals aren't without their complexities, so it is key to engage a broker who understands these types of transactions and the key issues. Thanks to our experience in and knowledge of the M&A insurance market, we can advise on the insurance solutions available for each transaction depending on its specific features.

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