Carving Out and Cashing In

by Will Hemsley and Adrian Furlonge

Long gone are the days when Warranty and Indemnity ("W&I") Insurance and other Transaction Liability Insurance ("TLI") policies were solely used by private equity. Corporates, whilst probably the last to the party, are now getting the benefit of structuring their transactions using insurance to manage risk or free up cash by not creating long tail balance sheet exposures. In particular, we are seeing corporates (and sometimes PE backed portfolio companies) using insurance backed solutions to allow them to dispose of noncore assets, divisions or parts of a business by way of a corporate carve-out. HWF are regularly instructed to advise on and structure W&I and other TLI policies on these complex transactions to allow sellers to make such disposals without creating significant retained liabilities. In this note we explore the key considerations unique to carve-out transactions where a seller or buyer is contemplating the use of insurance:

1. The re-organisation/carve out itself

The starting point of the insurers is to seek to exclude the liabilities arising out of any reorganisation, which will often be problematic for buyers. However, if a detailed diligence exercise is undertaken (including analysis of the steps plan) cover may be available for certain aspects of the re-org risks. Most commonly cover is sought for potential tax exposures or employment transfer risks. Where matters are complex, liabilities may need to be covered via more than one policy either because the liabilities are best insured under a contingent policy as opposed to a W&I policy or because certain insurers may wish to insure some of the risk areas but not others. It is also worth noting that to obtain broad cover under a W&I policy, the carve-out/re-org should either have happened already or be happening as part of the transaction steps. If sellers are able to approach the market in advance of their sale process, cover for specific tax or other contingent liabilities associated with a re-org can be secured in advance of the re-org taking place to mitigate negotiation issues with the buyer/bidders in the heat of the deal.

2. Accounts

Very early on in a process we need to understand if the business/assets being sold have stand-alone audited accounts or whether their accounts are part of the consolidated group accounts. If the latter, it is important for sellers to draw up pro forma carve-out accounts so that the buyer and insurers can adequately diligence the financials. Buyers and insurers will naturally be more comfortable with a carve-out audit process having been conducted, however, this is often not the case and insurers are happy with unaudited accounts so long as the warranties being given, reflect the basis of preparation.

3. Transitional service agreements (TSAs) / Wrong pockets clause

The fact that most carve-outs will have these is a huge positive for insurers and is often overlooked when approaching the insurance market. One of the biggest areas of comfort for an insurer should be that aside from traditional mitigants (such as insurances) carve-out transactions have TSAs and wrong pockets clauses as contractual remedies outside of the warranties to deal with many post close issues. Thought needs to be given when approaching insurers as to what risks they can and cannot cover around the edges of the TSAs and wrong pockets clauses to ensure correct insurer selection and to ensure potential exposures do not fall in the gaps between the policy and the contractual protections.

4. Specific identified or known risks

Where a matter exists within the carved out business (or indeed a secondary liability) that may be unpalatable to a buyer, but the seller cannot or is unwilling to retain, a seller should think about the applicability of an insurance solution that wraps up the specific item and removes it as a value item from the purchase price. Whilst traditionally such issues were approached almost always from the buy side we find that approaching these issues on the sell side gives us the benefit of having access to those that understand the background, access to the advisors who have been instructed to deal with or advise specifically on the issue often resulting in more favourable advice and, most importantly, we have the benefit of time. The issues we see are high quantum, low probability events across a broad spectrum of areas such as tax, litigation, pensions, environmental and TUPE.

5. Secondary liabilities

As well as the secondary liability contingent risks mentioned above, we have also seen risks associated with parental company guarantees requiring insurance where the assets are being sold to private equity who would always be unable to stand behind such guarantees. In general the key point about secondary liabilities is that these are often not the subject of due diligence or disclosure but where there is a carve-out could have a material impact on the business being sold. It is worth understanding what could exist early in a process and seeing what can be covered under the W&I or under separate policies to avoid last minute deadlock between buyer and seller. Some, but not all insurance policies have a secondary tax exclusion. In light of the above it is important that the drafting of the exclusion is narrowed as far as possible.

6. De-grouping of the Target's insurance programme

As the Target's existing insurance programme may be held by the parent company, it is important to be able to demonstrate that adequate insurances at the target level will be available pre signing, between signing and completion and post-completion. Some insurances will be able to cover retrospective periods, others will not. Insurers will find it particularly problematic where (as is sometimes the case with large corporates) the selling group self insures or uses a captive solution. In such instances, the buyer will need to demonstrate that any claims made policies put in place at completion extend the cover to retroactively cover historic periods. As an additional point, it is beneficial for a buyer to seek (or for the target) to have adequate insurances for the businesses operations as the excess levels on these policies are often low in comparison to the excess levels on a W&I policy. This is because the excess levels on the targets policies are calculated with a specific event or issue in mind whereas the excess levels on W&I or TLI policies take into account the impact of the valuation methodology and how loss will be calculated accordingly.

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