

LOUISVILLE BUSINESS FIRST

GUEST COMMENT

M&A, private equity trends to help you cross the finish line

It is no secret that private equity (“PE”) firms are significant drivers of merger and acquisition (“M&A”) activity, including in the middle market.

With large cash reserves and a favorable environment in the capital markets, PE groups continue to target aggressively both potential platform companies, and, perhaps more commonly given the higher cost of platform buys, add-on acquisitions in a broad variety of industry sectors.

However, even if you are a strategic buyer focused on growth through M&A or a business owner considering a change in control transaction without any PE involvement, trends in the M&A markets influenced by PE could impact your approach, and, ultimately, the success or failure of your potential transaction.

For M&A dealmakers, this includes an evolving range of standards in documentation and deal terms regarding what is considered customary or “market,” which can vary considerably depending upon factors such as the nature of the particular industry, the target’s risk profile, including regulatory considerations, and the relative bargaining power of the parties.

One example is representations and warranties (“R&W”) insurance, which, after years of use by PE to facilitate fund liquidations and separation following the sale of a portfolio company, may be transitioning more to the mainstream in M&A deals. With R&W insurance, an insured (buyer or seller) purchases insurance covering losses resulting from breaches of the representations in an M&A purchase agreement.

In general, these policies cover “unknown” liability for a breach that surfaces after the closing as opposed to “known” liabilities or specifically identified contingencies.

What are some of the advantages of R&W insurance? For a buyer in a competitive bid



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or auction format, this can help differentiate the buyer from competing bidders and potentially lead to a more streamlined process. It can also help bridge the gap where buyer and seller have widely divergent views on indemnity and risk allocation.

For sellers, the use of R&W insurance can help achieve a clean break from the business and limit exposure to post-closing indemnity claims. In other words, by using R&W insurance as either a supplement to or a replacement for traditional indemnity provisions, a seller and its principals can shift risk to a third party and lessen personal liability, allowing for more economic certainty and less need to look in the rear-view mirror once the transaction closes.

Sellers may also receive a higher percentage of the purchase price at closing.

Due diligence by the carrier is a critical part of the underwriting process for R&W insurance. Carriers want to be satisfied that the buyer and the parties’ advisers are experienced in M&A. The insurer will have a particular focus on identifying the target’s material liabilities.

This process includes reviewing detailed diligence reports, management interviews in certain cases and approving documentation, including disclosure schedules and exceptions to the representations. Representations would be benchmarked against what is considered market for similar deals.

There would be insurance policy exclusions that go beyond fraud and intentional misrepresentation, but these can vary depending upon the circumstances. Nonstandard representations would be excluded from coverage, as would matters such as working capital adjustments, amounts tied to unfunded or underfunded pensions, asbestos and other types of environmental claims.

Given the costs associated with R&W insurance, the product may not be feasible for deals on the smaller end of the scale. Although it is hard to generalize, carrier diligence and underwriting costs could range from \$25,000 to \$40,000, with premiums from 2 to 4 percent of the deal size. The minimum risk retention for the parties to the transaction would likely be at least 1 percent.

In summary, the M&A marketplace is dynamic, and it is critical that buyers and sellers understand current developments that can help lead to successful outcomes. Although R&W insurance is not a perfect fit for every situation, you may want to explore this option. 