Mergers & Acquisitions Insurance — Part II

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This is the second of two Trends Papers on transactional risk insurance. The initial paper focused on Representation and Warranty (R&W) Insurance. As noted in that paper, transaction risk insurance products provide the participants a way of transferring risks that might arise in connection with specific aspects of the transaction.

Though R&W Insurance is by far the most common transactional risk insurance, two other products have also been developed to cover specific kinds of transactional risks:

- Tax Indemnity Insurance (sometimes called Tax Liability Insurance), and
- Contingent Liability Insurance (sometimes referred to as Contingent Risk Insurance).

This Trends Paper focuses on these two types of insurance.

Two inherent differences between R&W Insurance and Tax Liability and Contingent Risk Insurance are:

- R&W Insurance provides coverage for risks that are unknown at the time the policy is bound, while Tax Liability and Contingent Risk Insurance are for issues that are identified before the policy is bound.
- Retentions on R&W policies are based on a percentage of deal value, while retentions for Tax Liability and Contingent Risk are risk-specific.

Both Tax Liability and Contingent Liability Insurance are meant to cover situations where the likelihood of the liability is low, but the potential amount of liability is substantial.

As with R&W Insurance, brokers often market Tax Liability and Contingent Liability Insurance to lawyers who are involved in mergers and acquisition deals, and investment bankers. Such policies are seen as tools that allow transactions "to close more quickly, without either party assuming undue risk or limiting or impairing the sales proceeds from the transaction."

While there's a fair bit of information available about the claims history on R&W policies, there isn't much data available about the claims history for Tax Liability or Contingent Risk Insurance. Michael Turnbull, AIG's North America M&A Manager explains, "There are relatively few of these policies written compared to R&W, so it's more difficult to draw any conclusions on claims activity."

TAX LIABILITY INSURANCE

Tax Liability Insurance is the second most sought after transaction risk coverage and it's becoming increasingly common for a deal to include both R&W Insurance and Tax Liability coverage, according to James R. Swan, Head of Americas, Liberty Global Transaction Solutions. AIG's experience is similar. Turnbull says, "We've seen an increase in Tax policies in Canada in the last 18 months in particular — some of those have come in conjunction with an R&W policy, others have not necessarily had an R&W policy on a deal. Tax policies still aren't as common in Canada as they are in the United States, but there is increasing awareness of the product, and increasing appetite for insureds to buy the cover."

Like other types of transaction coverage, interest in Tax Liability Insurance often emerges during the due diligence process for transactions. It can be used to reduce or eliminate financial loss arising from a tax authorities' successful challenge of the tax treatment of a transaction , or it can be used to protect against a tax position taken by a party to the transaction, or where the tax authorities refuse to provide an advance ruling on an identified tax issue. It's generally not available for tax issues that are already subject to an audit by the tax authorities. For obvious reasons, it's also not available for potential liabilities arising under a tax avoidance scheme.

To qualify for coverage under a Tax Liability policy, the opinion(s) provided by tax counsel must be strong — in other words, the professional tax advisors must be of the view that with respect to the issue, the tax liability "will not arise" or "should not arise". "If someone is putting a probability of 50% — 60%, then that's probably not an insurable risk," says Swan.

"Request for coverage for uncertain tax positions arise in transactions on both the Buyer Side and Seller Side. A buyer may seek coverage in order to lessen their successor liability and a seller may seek coverage as part of its preparation for sale," says John Antonecchia, head of the M&A practice at BFL Canada.

"One uncertain tax position we often see in Canada," says Antonecchia, "revolves around whether Canada Revenue Agency will treat assets as Taxable Canadian Property. If you have a non-resident seller of a business, if the assets qualify as Taxable Canadian Property, the buyer is expected to withhold a portion of the proceeds of the sale of those assets. Under certain tax treaties, foreign sellers can transact without any withholding. However, the CRA will opine that the transaction is 'Treaty Exempt' from Taxable Canadian Property withholding. This can be a contentious situation/gating item in a transaction. The buyer's in a situation where they're required to withhold and the seller believes they are Treaty Exempt and reluctant to accept any sort of withholding of transaction proceeds — transaction tax insurance can help bridge the gap," explains Antonecchia.

Two basic types of Tax Liability coverage are available:

1. Tax Risk Insurance (sometimes referred to as Tax Opinion Indemnity Insurance) — it covers the risk related to tax liability — in other words, something that causes the insured to have to pay tax to a tax authority, and
2. Tax Credit Insurance — it protects the insured against the loss of tax credits and tax benefits.

Though the accountants and tax lawyers that provide opinions with respect to tax matters likely have Errors and Omissions Insurance, such insurance isn't sufficient to meet the needs of the parties to the transaction because it is meant to cover negligence of the person providing the opinion. Given the complexities of tax, the fact that a tax professional may have ultimately been incorrect in their conclusion regarding the tax treatment doesn't necessarily mean they were negligent. In contrast, the triggering event for a Tax Liability policy will be a decision by the tax authorities that the proposed tax treatment was inappropriate and so it alleviates the uncertainty associated with the tax treatment.

Of the two types of Tax Liability Insurance, Tax Credit Insurance is far more common in North America, says Swan, while Tax Risk Insurance is more common in Europe.

"Tax credit coverage is very common, for example in the renewable energy sector, where tax credits are one of the primary incentives to encourage investment in renewable energy projects. Institutional investors are attracted to provide funding for the projects through tax equity, but these tax equity investors are subject to a number of tax risks, such as the project's not qualifying for the expected tax benefits, the structure not being respected, or the loss of the benefits through recapture. Institutional investors are regularly looking to tax insurance to address those risks," Swan says.

When it comes to negotiating Tax Liability coverage, definitions of "claim" and "loss" are of utmost importance and generally customized in each policy. "Claim" defines your coverage trigger and correlates directly with the uncertain tax position. "It's important to work with tax counsel and the insurer to define the trigger effectively to ensure it meets the expectations of coverage," says Antonecchia. "Loss" defines what's included and excluded within the coverage. "Loss may include additional taxes, interest, and penalties assessed because of a determination regarding the insured tax position," according to Antonecchia.

THE UNDERWRITING PROCESS

When a broker is engaged to place Tax Liability coverage, they put together a submission that they take to the market. “Generally, what insurers are going to need is some sort of opinion from a tax lawyer or tax specialist. Previously, insurers would require a ‘should’-level opinion from your tax specialist to consider coverage. As transactional insurance has evolved, underwriters may be able to get comfortable on specific tax issues, if they have a narrative equivalent to a ‘more likely than not’ tax opinion from a 3rd party tax advisor,” says Antonecchia.
Market appetite can vary depending on the specific uncertain tax position, and therefore it’s important to qualify the risk with insurers before relying on insurance as a potential solution. In the event R&W Insurance and Tax Liability Insurance are sought on a particular transaction, the same insurer may not necessarily insure both coverages, according to Antonecchia. “You’d still market the Tax Liability separately because you would need the markets to qualify it. There may be economies by packaging R&W and Tax, however you could have a situation where a single insurer may be too exposed on a single transaction,” he says.

From this information, interested insurers will provide a non-binding indication that would include a price range and high-level terms related to things like the limits and likely exclusions. As with R&W Insurance, if the client decides to go forward with the insurance, they choose an insurer and pay an underwriting fee. The underwriting fee depends on the complexity of the tax issues and the documents that need to be reviewed. Swan says that, typically, the fee doesn’t go as high as the fee on a Contingent Liability underwriting. “It can be as low as U.S. $20,000 but it can go as high as U.S. $50,000 - $70,000,” says Swan.

The underwriting process itself very much depends on the risk, according to Swan. The underwriter engages outside counsel who will review the documents and tax opinions and are likely to raise a number of questions.

COST AND COVERAGE PERIOD

In North America, the premiums for Tax Liability have fallen dramatically in recent years, says Swan. “They range anywhere from 125 basis points to about 300 basis points [of the coverage limits] for Tax Credit Insurance. Tax Risk tends to be higher — in the 2% to 10% range, depending on the nature of the risk, but the market is very fluid,” he says.
Tax Risk Insurance can address tax exposures arising domestically (federal, provincial, or local) or foreign. It reimburses the insured for additional taxes, interest and penalties and can cover expenses for legal and financial advisors hired to assist in resolving disputes with tax authorities. Coverage typically extends for the applicable statutory limitations period, which in Canada, for example, is six years. For Tax Credit coverage, the policy is typically in force for the recapture period, says Swan.

CONTINGENT LIABILITY INSURANCE

Contingent Liability Insurance — or Contingent Risk Insurance — is designed to address unique litigation liability exposures. "It's designed to cover catastrophic losses — situations where the likelihood of loss is very small, but the potential quantum of loss is so large that the insured can't take on the risk, no matter how remote it might be," explains Swan. It's not uncommon for litigation exposures to be uncovered — whether existing third-party claims or potential claims — during the due diligence process in a transaction. If the parties agree on the scope of the exposure, the parties could deal with it through an indemnification. But, if the parties cannot agree, Contingent Liability Insurance should be explored.

Contingent Liability coverage has been used for a myriad of claims, such as:

- environmental exposures,
- employment claims,
- contractual disputes,
- claims involving intellectual property,
- product liability, and so on.

A lawsuit doesn't need to be pending in order for Contingent Risk Insurance to be bound. "There could be a risk out there but it hasn't been solidified or you're not yet aware that litigation is pending — it could just be a threat of litigation. It's certainly easier and more likely that insurance will be available if the facts are established in pleadings because underwriting decisions can be based on the facts," Swan says.

It's important to note that Contingent Risk policies are not just intended to cover litigation buy-out situations. "A contingent risk is really an identified issue where you can do an analysis of the likely outcome, and the likely quantum of the outcome. So theoretically, it could be an issue that hasn't actually developed into litigation," says Turnbull. "The market is selective on litigation risks. The policy retention/deductible will need to make sense for the fact pattern. There'll often need to be an alignment of interests between the insured and the insurers. Insurers typically like there to be a sound rationale for seeking insurance, and that can often be a pending transaction. We've seen markets look at coverage of issues outside the context of transactions, however," he adds.

Because no two litigation risks are the same, no two Contingent Liability policies are the same. "This solution is far more tailored to the specific situation than the other transaction risk solutions," says Swan.

Contingent Liability coverage has been around for a long time, but its use has grown dramatically in recent years. It tends to be used more in North America than Europe, says Swan, who has been involved in transaction liability insurance in both markets.

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Swan estimates that between eight and 15 insurers “have an appetite for Contingent Risk” but their appetite varies. “An insurer’s appetite might depend on the sector, the interests of the insured, the facts of the situation, among other matters, but this appetite can vary over time,” he says.

When it comes to negotiating Contingent Risk coverage, the four most important elements are:

- The event trigger
- The definition of loss
- The exclusions; and
- The description of the insurer’s right to input in the conduct of the case.

THE UNDERWRITING PROCESS

As with other transaction risks, the broker goes to market seeking expressions of interest. Depending on the limit being sought, coverage might be with one insurer or a program of insurance involving more than one insurer. “As an insurer, we may say ‘we quite like this risk and we want to write the primary policy’,” says Swan. “Or we like the risk but we would prefer to provide excess insurance,” he says. “Capacity for contingent risks has increased in recent years, but limits above U.S. $20 million usually will need more than one insurer, although not always. Each insurer has a different maximum capacity for Contingent Risk Insurance, so as bigger and more complicated contingent risks are insured, it may take a number of insurers to get the limit you’re looking for,” he says.
If, after receiving the indications and having an idea about the cost, the insured chooses to proceed, they pay the underwriting fee and the process starts. Because the underwriter will hire outside counsel and perhaps other experts with sector-specific knowledge for advice, the underwriting fee varies. “It could range from U.S. $45,000 — $50,000 but it can be as high as U.S. $150,000. That’s really a reflection of the volume of materials that outside counsel needs to review in the underwriting process that gets insurers comfortable with the risk,” says Swan.

In order to avoid a price reduction, sellers are increasingly presenting businesses for sale with an insurance solution already prepared.

The turnaround time — the time from when underwriting begins to when a bindable policy is ready — depends on the availability of the information. It can be as little as two weeks if the insured has all the information and it’s simple and with just one insurer, says Swan. “The solution has been used successfully where an issue is known in good time and the underwriting can be carried out in a managed way. For example, it has been used successfully when a seller is preparing a business for sale but understands there’s a remote risk faced by that business for which a buyer may want a price reduction, even though the risk might be low. In order to avoid a price reduction, sellers are increasingly presenting businesses for sale with an insurance solution already prepared. By addressing the issue in advance, the seller can work with their broker and an insurer to structure a policy which addresses the issue and takes it off the table for an incoming buyer," he says. "That gives the seller more control to their process and reduces the risk of a price chip," he adds.

COST AND COVERAGE PERIOD

Premiums vary between 5% and 25% of the limit of liability, says Swan. "The premium can vary significantly, depending on the risk. Whether there's a retention depends on the risk. In some situations, it's binary — all or nothing, so there might be no or a limited retention," he says. In some situations, an insurer may require co-insurance, whereby the insured shares a portion of the loss.

The coverage normally lasts for as long as the contingent risk might exist. In litigation situations this might be until a final, non-appealable judgment. Insurers may have restrictions on the terms of their policies, for example, to a maximum term of 10 years. In such cases, a well-structured policy will include provisions that extend the term beyond 10 years in the event the risk remains extant.

Tax Liability and Contingent Risk Insurance typically round-out the suite of solutions insurers offer for transaction risks. But, it's worth noting that such solutions can also be used in non-transaction situations. An example Swan mentioned is a situation where a pending lawsuit might be "weighing heavily on a corporate balance sheet and the company may want a solution that takes something they had to reserve against off their balance sheet or draws a line under an issue." In such situations, he said, Contingent Risk Insurance may be a viable option.

As well, Tax Liability Insurance can be used to transfer a known, but uncertain, tax liability from a company's balance sheet to an insurance company.