WOODRUFF SAWYER

2020 TREND REPORT

Private Equity and Transactional Risk Insurance

TABLE OF CONTENTS

Executive Summary 3

General Partnership Liability

BY DAN BERRY

Transactional Risk

BY EMILY MAIER

General Partnership Liability: Market Update 4

BY DAN BERRY AND LUKE PARSONS

Cyber Liability Gains Traction at the Fund Level 6

BY LUKE PARSON AND DAN BURKE

Representations and Warranties Insurance: Market Update 9

BY EMILY MAIER AND LUKE PARSONS

R&W Insurance: Current and Upcoming Trends 10

BY EMILY MAIER, LUKE PARSONS AND TYSON FREEBURG

R&W Insurance: Claims Update 13

BY YELENA DUNAEVSKY, ESQ.

The Rise of Tax Liability Insurance 15

BY EMILY MAIER

Executive Summary

General Partnership Liability

Woodruff Sawyer has been working with private equity and venture capital firms at the fund level for over 25 years. As we approach 2020, we're beginning to see signs of a hardening market pertaining to fund-level general partnership liability. This is largely due to the shrinking profitability of these books of business on insurers' balance sheets as losses continue to develop. New government regulations and compliance requirements are also causing more scrutiny at the fund level. Finally, new exposures such as cyber liability are making their way into the private equity and venture capital space, and not just at the portfolio company level. Owners, investors, and BoD seat occupiers are beginning to be held responsible and accountable for incidents not only within the funds themselves, but also downstream at the portfolio company level. Across our client base of 300+ funds in the United States, these are just a few issues that are fundamentally reshaping how GPs, CFOs, COOs, and GCs view and consider risk pertaining to the funds. This report offers an in-depth analysis of these trends and how funds can prepare themselves adequately as we move into 2020.

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Transactional Risk

The market for representations and warranties insurance (R&W) continues to evolve, but as R&W solutions have increasingly become table stakes for middle market transactions (both the core and now the lower middle market—more on that in this piece), we've noticed the market for innovative risks is expanding. We are also seeing a higher utilization rate of tax indemnity and other contingent liability solutions, which are still growing and evolving as more competition enters the market. As transactions across the middle market become more complex, we continue striving to bring new and solutions to our private equity, venture capital, and strategic clients to help them get their deals across the finish line. The second portion of our trending report offers an update on the core R&W insurance marketplace as well as several insights regarding recent trends we expect to continue gaining traction in 2020. Finally, we offer an in-depth review of the claims atmosphere, a topic around which every client or first-time buyer wants more information.

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Back to TOC ›

General Partnership Liability: Market Update

Given the current dynamics in the general partnership liability (GPL) insurance marketplace, private equity and venture capital CFOs, COOs, and controllers would be wise to perform a comprehensive review of the fund-level coverage terms, conditions, and pricing as we head into 2020. Broadly speaking, a GPL program includes fund-level directors and officers liability, employment practices liability, professional liability, and outside directorship liability. Across Woodruff Sawyer's client base of over 300+ fund-level clients and in working alongside underwriters across the United States, we are seeing signs of a maturing market on GPL coverage.

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THE TIDES MAY BE TURNING

Across our Private Equity and Venture Capital Practice, we have seen a steady rise in the number of insurers getting into the GPL marketplace. As we've also seen in the R&W insurance marketplace, new entrants into the market will frequently undercut pricing or retention in order to gain market share. Initially, this has a positive effect for clients' renewals as competition is strong, pricing relief occurs, retentions are favorable, and terms expand. This general dynamic has proliferated for the better part of a decade, much to the benefit of the insureds. In the beginning of 2019, we started to see a shift in this dynamic/market. As the market has matured, claims have steadily risen across the PE/VC space from a frequency perspective. Couple that with a dramatic, industry-wide increase in defense cost and settlement values in claims, and insurers' profitability has been negatively affected. This is leading insurers to seek rate and/or retention increases across all GPL programs.

According to an underwriter with whom we spoke, insurers are realizing that "rates strengthen in the PE space because we and many of our competitors continue to have sizable claims." After an actuarial review, his group has identified a 20%–30% rate deficiency across the broad book of PE/VC book of business.

FACTORS DRIVING THE CLAIMS LANDSCAPE

Another top-tier underwriter with a large GPL book of business notes two significant drivers behind the increasing claims landscape, the largest of which "can be drawn directly to the portfolio companies, whether the claim occurs during the investment stage, exit process, or continued management of the portfolio company." In addition, the more severe losses tend to be linked to a portfolio company declaring bankruptcy, as the investment company is held liable for either directing the company in the wrong direction from the board level or over-leveraging the companies at an unsustainable level.

Claim activity at the portfolio-company level is a key driver in the increasing claims landscape for GPLs.

Finally, the cost of defense is another area of concern for underwriters in 2020. According to one underwriter with whom Woodruff Sawyer works routinely, the "cost of defense has skyrocketed over the last several years" as PE and VC firms "are utilizing counsel with partner rates soaring well above $1,200 per hour."

What Private Equity and Venture Capital Fund CFOs Should Expect in 2020

As we move into 2020, we anticipate that GPL underwriters will tighten their underwriting approach, resulting in increased premiums, as well as retentions, even at the lower end of the investment spectrum. For limits less than $5 million, funds of any size assets under management (AUM) should expect minimum retentions of $100,000–$150,000 and minimum premiums of $15,000–$25,000. For firms with less than $100 AUM, we anticipate the interest from the marketplace to be low.

For programs with limits between $3–5 million, fund managers should expect retentions to be renegotiated to $150,000–$250,000. Above $5 million, we believe the marketplace will move more towards the $500,000 retention. A key driver of retention negotiation will be the structure of the fund. VC firms will not experience as significant of an increase as their PE leveraged-buyout counterparts, largely driven by the bankruptcy concerns noted above from over-leveraging the portfolio companies.

WHAT INSURERS SAID IN OUR SURVEY

We conducted a brief survey from a pricing perspective and each insurer said it would seek rate on their entire book of business given recent profitability concerns. We believe this trend will continue throughout 2020, beginning with East Coast clients. On the low end, one underwriter believed 5%–10% increases could become the norm, with another indicating that their average YTD rate increase in 2019 is +15%, expecting that the trend will continue in 2020. All survey participants qualified their responses regarding rate increases, indicating that if the fund had experienced any claim activity during the prior 12 months or the AUM had increased due to a recent rise in funds, the rate increase would likely be more significant.

For limits less than $5 million

› expect minimum retentions of $100,000–$150,000 and minimum premiums of $15,000–$25,000

For limits between $3–5 million

› expect minimum retentions of $100,000–$150,000 and minimum premiums of $15,000–$25,000

Back to TOC ›

Cyber Liability Gains Traction at the Fund Level

As with most industries, private equity and venture capital firms increasingly face significant cyber risks, and those risks continue to evolve. In addition to the fund itself, nearly all portfolio companies face cyber risk, and an incident can potentially significantly impact EBITDA—the underlying value of the company—thereby adding another layer of complexity to the mix.

Aside from the dynamics and risks involved during a portfolio company's transaction itself, PE firms are encountering new daily risks at the fund level. As we move into 2020, there are several cyber exposures CFOs and COOs of PE and VC firms face:

- Sensitive corporate information
- Ransomware
- Phishing attacks
- GDPR/CCPA compliance

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How are Private Equity Firms Tackling the New and Evolving Exposures?

In January 2019, Woodruff Sawyer co-sponsored the Private Equity International CFO & COO Forum in New York City. During the conference, several hundred PE CFOs and COOs gathered to discuss new and emerging topics, and cyber liability was a key topic of discussion. Below is a synopsis of how their roles are evolving in 2019 pertaining to cyber security as well as the new ways in which their firms are tackling the emerging exposures:

- **Fund-Level Risk Assessment:** Engage third parties to help understand and assess the cyber risks faced by the fund and any currently compromised credentials, email addresses, etc.
- **Penetration Testing:** Utilize third-party advisory firms that specialize in cyber security to identify vulnerabilities, validate current controls, and implement proactive measures to enhance their network security.
- **Incident Response Planning:** Prepare for a cyber incident by implementing an incident response plan and, importantly, testing the plan to make sure it works. These types of tabletop tests have become popular across many industries, as data shows that an effective and timely response to a cyber incident reduces the ultimate impact of the event, from both a time and cost perspective.
- **Outsourcing Data Hosting:** Outsource data collection and storage—both at the fund management level and portfolio company level—which may contractually transfer the liability to a third party.
- **Due Diligence:** Increase due diligence efforts around cyber risk and cyber insurance for ongoing acquisitions—whether by the insurance due diligence provider or third-party cybersecurity firms.

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Will a Fund's General Partnership Liability Program Respond to a Cyber Security Loss at the GP and/or Portfolio Company Level?

Most GPL policies do include coverage for errors & omissions related to the operation and management of the fund, but typically there is no affirmative coverage grant included in the policy language related to cyber liability. The only mechanism by which coverage for cyber-related losses pertaining to the fund itself or GPs of the fund, is through a standalone cyber liability insurance policy. A standalone cyber policy will provide coverage for the network security and privacy elements that should be the primary focus for private equity and venture capital firms.

The only mechanism by which coverage for cyber-related losses pertaining to the fund itself or GPs of the fund, is through a standalone cyber liability insurance policy.

To be clear: A general partnership liability policy for the private equity firm typically will not respond to a cyber security loss at the portfolio company level or vice versa.

Cyber risk can carry a variety of consequences, which ultimately may impact many different insurance policies. It is imperative for private equity firms to undergo an assessment of all of the possible insurance policies that might respond to a cyber incident, as many policies remain silent on cyber risks or provide some element of affirmative coverage for very specific exposures, such as funds transfer fraud, also known as "social engineering." This exposure can sometimes be covered on a cyber liability policy, but is typically better suited to be covered on a commercial crime policy issued at the fund level.

What to Expect in 2020: Terms, Conditions, and Pricing

Cyber security risks and exposures continue to evolve and new threats are emerging. CFOs and COOs of private equity and venture capital firms are growing more aware of not only the risks to their funds, but also their responsibility as stewards of the fund assets to protect them from ongoing and emerging threats. Across the spectrum of fund-level clients at Woodruff Sawyer, the large majority have already implemented cyber liability coverage or are planning to do so as part of the next renewal cycle. We see this as a critical coverage for the funds.

As regulations like GDPR and CCPA come into effect, we are negotiating with the cyber liability insurance marketplace to implement new coverage enhancements for these regulations. It is important to understand exactly what is and isn't covered as far as these new exposures. For example, some insurers may only provide coverage in certain circumstances and may not provide coverage for non-compliance fees. The endorsements should clearly state and affirmatively grant coverage related to GDPR and/or CCPA.

Terms and conditions outside of GDPR and CCPA remain fairly broad as the marketplace for fund-level cyber liability coverage continues to evolve. There have not been catastrophic losses in comparison to retail, for example, so we anticipate renewal pricing to be flat to nominal increases. Retentions are also staying relatively low. As more insurers begin offering cyber liability coverage to the private equity and venture capital community, pricing will likely continue to be driven downwards until losses begin to accrue. But, it is important to understand the reputation of the insurer, their rating process, and their claims management capabilities. For example, we see several insurers that rate a policy based off of AUM versus total annual management fees. Given the discrepancy between the two, this can lead to vastly different premium amounts.

One final way in which the private equity and venture capital community can assess, prepare, mitigate, and combat cyber risk is by partnering with an expert insurance advisor at both the fund and portfolio company level. Woodruff Sawyer recently introduced a robust Cyber Services Network as part of our Cyber Services, which includes a full network of cyber experts to help clients strategically address their cyber risk. This network is helping clients with services such as risk assessments, penetration tests, incident response planning, and due diligence, among others.

The private equity and venture capital community can assess, prepare, mitigate, and combat cyber risk is by partnering with an expert insurance advisor at both the fund and portfolio company level.

Back to TOC ›

Representations and Warranties Insurance: Market Update

For core middle market private equity acquisitions, there has been a longstanding belief that it is more beneficial to have indemnification language and corresponding escrow than it is to have insurance that will pay for breaches of reps under a purchase agreement, especially if the buyer can negotiate a large escrow. We are seeing an evolution in this thinking, which has led more buyers to utilize a representations and warranties (R&W) insurance policy as part of the transaction.

At the core of the argument is this: while it may appear to be "easier" to target an escrow in the event of a breach because it's available cash, the types of reps and warranties given and the very heavily negotiated indemnity language can actually make it harder to utilize than a buyer imagines. On the other hand, once R&W insurance is introduced into the process, the representations and warranties given are often more buyer-friendly and the indemnification package much less heavily contested.

From a terms and conditions perspective, we are still in the interesting position of plenty of competition even though claims rates are rising sharply. We have not seen a lot of new entrants in the last year and the 21 markets we have seem to be holding their terms, conditions, and pricing mostly steady. At the same time, we are also seeing more push back and less interest for more challenging risks.

As we approach Q1 2020, here are the basic market updates for the R&W insurance marketplace:

- **Number of Insurers:** 21
- **Limit:** still averaging 10% of total enterprise value, but it's worth noting that number can get skewed by a very small or very large deal. We also counsel our clients to think through the likely outcome of the most important reps in order to come at a more considered limit.
- **Pricing:** 2.5%–3% of limit purchased
- **Retention:** 1% of enterprise value, although this can drop on the biggest transactions to 0.75%

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R&W Insurance: Current and Upcoming Trends

Trend 1: Utilization by Strategic Buyers

We have seen the use of R&W insurance on strategic acquisitions by our large public and private company clients gain steam in recent quarters, and we expect this to increase in 2020 due to continued use by these same clients and the trickle-down effect on sizable private clients. Some of Woodruff Sawyer's large strategic acquirers are now on their third and fourth R&W policies for sizable add-on acquisitions. This trend will continue for the same reason it gained steam so quickly in the private equity market: R&W insurance policies streamline the deal process and cut down on friction during negotiation.

The increased utilization with strategic buyers supports what we have seen in the auction process: on a transaction that is $50 million or more in value, an R&W insurance policy is table stakes to participate in the process. These buyers used to be able to get around this by simply negotiating better deals or offering a slightly higher purchase price. Now, though, they have found it harder and harder to compete with the private equity community.

The key for strategic buyers to effectively utilize an R&W insurance policy on a transaction is to understand what the R&W insurance underwriters will want to see throughout the underwriting process. First-time buyers can be overwhelmed at the level of due diligence required by underwriters. And, oftentimes, strategic acquirers do perform the diligence, but it may not be memorialized in a formal diligence report that is easily digestible to an underwriter. For an R&W process to be successful, similar diligence workstreams will need to be engaged (i.e., tax, financial, IP, insurance, etc.) and any internal diligence will need to be memorialized in a formal report or memo.

Trend 2: Movement Downstream

In 2019, we have noticed R&W underwriters are increasingly willing to underwrite smaller transactions. This has long been a desire of the lower end of the middle market given the benefit of the R&W insurance solution to both buyers and sellers and relative number of lower middle market deals in the marketplace. We are seeing policies with limits as low as $4 or $5 million being priced efficiently.

While this downward trend is good news for the LMM players, the number of insurers willing to participate at these lower limits remains low. The underwriting fee is also the same—the cliche is typically, "it takes just as much work to underwrite a smaller deal as it does a larger deal." With this in mind, we believe the market could move towards a more commoditized, streamlined policy format for smaller deals. There is already less ability to

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manuscript extensively on the smaller transactions. It's also worth noting that the extensive diligence done on larger deals is not necessarily the norm for smaller transactions, so that may be a limiting factor in the growth of this area.

Similar to strategic acquirers utilizing R&W insurance and needing to professionalize their due diligence workstreams, funds playing in the LMM and those sellers occupying the LMM could face hurdles as it relates to diligence. For example, family-owned and operated businesses valued at less than $50 million in enterprise value may not have audited or reviewed financials, and the prospective buyers may not be willing to perform a fulsome buy-side quality of earnings as part of their diligence process. From an underwriting perspective, it would be tough to obtain coverage for financial reps related to the deal.

For these reasons, we still believe R&W policies typically make the most sense for deals with a transaction value of $50 million or more.

While R&W insurers are increasingly willing to underwrite smaller transactions, funds and sellers in the lower middle market space could face hurdles as it relates to diligence.

Trend 3: Utilization on Minority Transactions

In addition to the movement downstream for smaller deals, we are also seeing R&W insurance underwriters more open to different structures for minority deals or growth equity deals. In a "typical" buyout transaction where the buyer is acquiring 100% of the target, the limit is 10% (average) of transaction value and any losses are paid 100% to the buyer as the first named insured on the policy. In the event of a seller rollover percentage, the policy pays out pro-rata based on the rollover percentage.

Recently, we have seen more underwriters getting comfortable with higher rollover percentages, going so far as insuring minority and growth equity deals.

Recently, we have seen more underwriters getting comfortable with higher rollover percentages, going so far as insuring minority and growth equity deals. On these deals, a standard 10% of transaction value for the policy limit is not being utilized; rather, the limit on the R&W insurance is based on the equity check the buyer is writing. This enables the buyer or holdco to still be identified as the named insured rather than the company. In the event of a claim, this allows the buyer who suffered the loss to be made whole. For example, if the minority investment is 48% and there is a $1 million loss, $480,000 would be paid to the buyer versus $1 million paid to the company.

The above trend is new and evolving, and supports the notion of R&W insurers moving downstream simply given that the 10% average will still apply, but for a smaller value based on the equity check. In the above example, if the total EV is $100 million but the buyer is acquiring 48%, the policy limit may only be $4.8 million versus the traditional $10 million for a 100% buyout.

There are also some underwriters willing to write 100% rather than a pro-rata payout on minority deals, although this will generally require an NCD be signed by the seller as well as the buyer.

Trend 4: Healthcare and Life Sciences Underwriting Expansion

Where a few lead, others will follow. We see this occurring most notably in 2019/2020 in the expansion of the underwriting appetite for healthcare and life sciences transactions. Two to three years ago, it was tough to obtain any coverage at all for Medicare/Medicaid reimbursement risk associated with a deal. In fact, if more than 20% of a target's revenue was driven by reimbursement, no underwriter would provide quotes. Or, if they did, they would simply specifically exclude Medicare/Medicaid, making the solution almost useless in the event of a claim.

As the market continued to develop one to two years ago, R&W underwriters began utilizing specialty divisions to underwrite the reimbursement risk, specifically. For example, two policies could be underwritten and placed: one for the reps outside of reimbursement risk, and another policy specific to the excluded risk on the core policy. This was a costly and inefficient way of insuring healthcare deals.

Today, as several insurers have now been profitable writing business in the space without rampant exclusions, we are seeing terms and conditions largely broaden around these types of risks. We have had underwriters quote deals where greater than 50% (and even up to 100%) of revenue was derived from Medicare/Medicaid.

Where a few lead, others will follow. We see this occurring most notably in 2019/2020 in the expansion of the underwriting appetite for healthcare and life sciences transactions.

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Back to TOC ›

R&W Insurance: Claims Update

AIG recently came out with its fourth annual claims report covering M&A representations and warranties insurance (R&W) claim data. The use of R&W in the United States has grown exponentially over the last few years. Although market participants from private equity firms to strategic acquirers are becoming increasingly comfortable with using the product, many questions remain around the claims process, the likelihood of payment, and the ability of the ever-widening circle of insurers to cover the claims.

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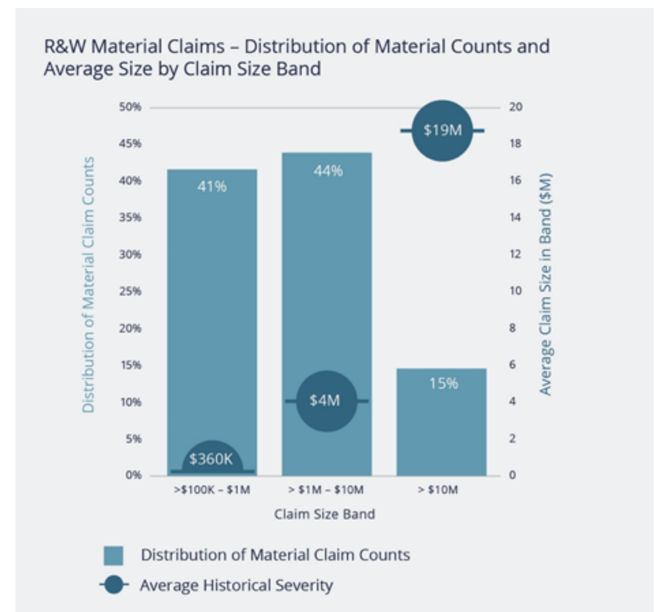
AIG's report comes at a critical time in the market and provides an overview of valuable claims data from over 580 claims. These claims came out of R&W policies that covered approximately 2,900 deals written by AIG between 2011 and 2017 in the US and internationally. A few key takeaways are as follows:

INCREASE IN CLAIMS SEVERITY AND FREQUENCY

- The proportion of claims over $10 million increased significantly when compared to last year, from 8% to 15%.
- The frequency of claims remains highest for the largest, most complex deals.
- Claims notifications for M&A deals between $500 million and $1 billion increased from 21% to 26% from the previous years.
- The overall frequency for all deals on a global basis stands at 20%, a constant over the last few years.
- Claims notifications are increasing in frequency, especially in the Americas, driven by increasing sophistication of the insureds.
- 74% of claims globally are notified within the first 18 months from policy inception, 29% within the first six months, but a significant number of claims (14% in the Americas) continue to come in after the first two years.
- In North America, nearly 50% of claim notifications are received after 12 months, which may cause the insurers to rethink their current practice of dropping the retention after 12 months.



MAIN CLAIM DRIVERS: BREACH TYPES

The main drivers of claims notifications globally continue to be:

- Financial statements (19%);
- Tax (18%);
- Compliance with laws (15%); and
- Material contracts (13%).
- Undisclosed liabilities, for which coverage has become more common in the UK, make up almost a third of all financial statement breaches.

The bulk of tax claims across all regions come from:

- Corporate income taxes, which will dominate tax breach notifications for years to come;
- Employment taxes; and
- Sales taxes.
- Franchise taxes account for over 5% of tax notifications in the United States.
- Breaches of fundamental representations, although a low risk, are not at zero. They make up 1% of all claims.

Breach types most prevalent in specific industry sectors include:

- Compliance with laws, which is seen in 30% of transactions in health and pharmaceutical industries and in 15% of transactions in the financial services industry;
- Intellectual property is responsible for 16% of claims in technology deals; and
- Material contracts make up 17% of claims in the financial services industry and 16% of claims in manufacturing transactions.

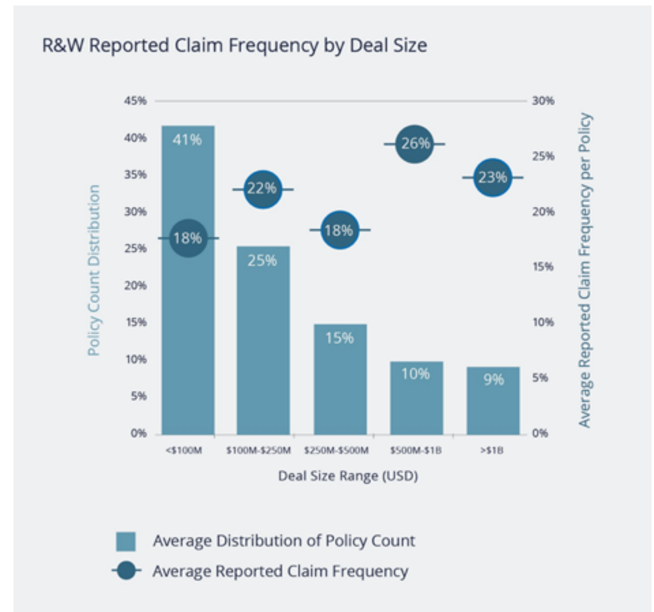
Woodruff Sawyer Projections

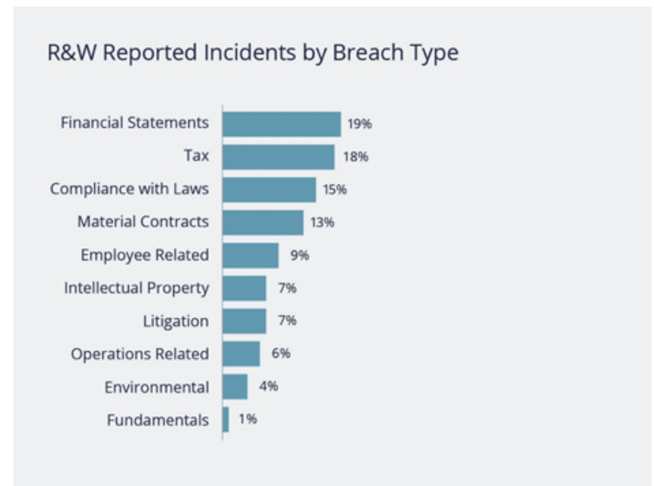
Competition among insurers entering the M&A R&W market is causing a decline in premium rates and the broadening of policy terms and conditions. However, the popularity of the product is also increasing the frequency of large claims, which creates a profitability challenge for the insurers.

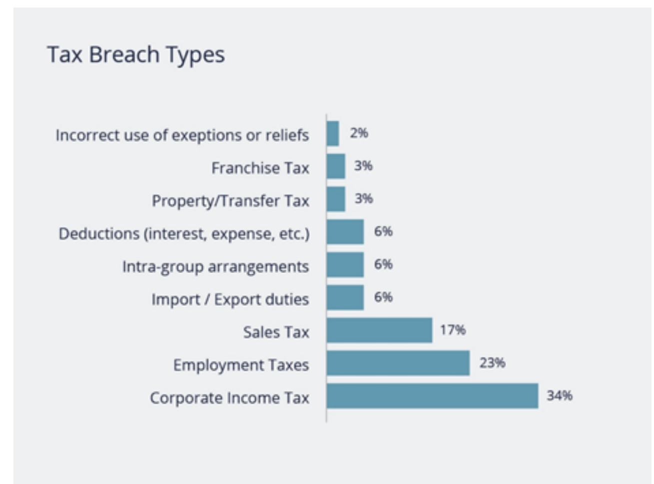
WE BELIEVE THAT OVER THE NEXT FEW YEARS:

- The use of R&W will continue to grow and eventually become standard practice in the M&A market.
- Some of the current insurers will be forced to exit the R&W market.
- More experienced carriers will continue to underwrite R&W policies and will make the placement process more streamlined and efficient.
- The insurance premiums will stabilize, likely at a higher than current level.

Back to TOC ›







The Rise of Tax Liability Insurance

While R&W is the most well-known of the transactional insurance products, 2019 has seen a significant uptick in the availability and utilization of tax liability insurance, also referred to as "tax insurance" or "tax opinion liability insurance." This transactional risk solution protects the insured when the IRS disagrees with a tax position they have taken.

Tax liability insurance is designed to address a very specific circumstance rather than provide general coverage that an R&W policy may provide. Said another way, a tax indemnity policy could provide coverage for a special indemnity related to tax that is specifically excluded on a common R&W insurance policy. This can often be more "deal critical" as tax issues can have a material impact on the upside of any transaction.

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Tax Liability Exposures Defined

Tax liability insurance, or TOL, protects a taxpayer against the failure of a tax position in connection with a transaction, reorganization, accounting treatment, investment, or other type of taxable event. Specifically, it covers your loss if the IRS or other applicable taxing authority deems you have a greater tax liability than what you've claimed. Tax liability insurance can cover a particular transaction, such as an investment in renewable energy, or the tax treatment of a spin-off, for example.

Why is Tax Liability Insurance Gaining Traction?

As R&W insurance has become standard in the majority of middle market transactions, insurance companies are continuing to expand their appetites in underwriting risks associated with complex mergers and acquisitions. If there is enough of an exposure where an insurer can adequately quantify the risk and assess a profitable premium versus losses, new products are developed. In the case of tax liability, the risk tends to be lower given the amount of due diligence required to underwrite a policy, and several R&W insurers are beginning to see their competitors profiting off of these policies.

The following are areas in which tax liability exposures can be insured:

- S-Corp status disputes
- Sales and use/nexus issues (provided a full nexus study has been completed by Buyer)
- Historic tax positions of a target entity in an M&A transaction
- Real estate investment trusts (REIT) and their representations as to their REIT status in an acquisition
- Foreign tax credits
- Preservation of (or availability of exceptions to any limitations to) net operating losses and other tax attributes following a transaction
- Transfer pricing
- Tax treatment of reorganizations, recapitalizations, and/or spin-offs
- Debt versus equity analysis
- Capital gain versus ordinary income treatment
- Deductibility of expenses (as opposed to capitalization)

Back to TOC ›

Possible Turbulence Ahead

As the R&W insurance marketplace remains largely profitable, competitors will continue to enter the marketplace and underwriting appetites will continue to expand. There are some brokers who believe the solution will be commoditized as competition continues to drive prices lower. While we do believe pricing will continue downward in the short term, retentions have remained flat and claims are beginning to rise. We do not believe the product will ever be truly commoditized.

There is some debate about whether a financial downturn is coming. If it does, we think we will see more claims made under R&W policies and more distressed risks going to market. This will inevitably lead to some hardening of the market and perhaps some markets withdrawing.

R&W insurance has become mainstream in the last four years in America. It is still in its infancy compared to other insurance products and we expect to see some turbulence in the market in 2020 if the economy becomes less stable.

While we do believe pricing will continue downward in the short term, retentions have remained flat and claims are beginning to rise. We do not believe the product will ever be truly commoditized.

More Resources from Woodruff Sawyer

- **Reps and Warranties Insurance—The Basics**
- **Representations and Warranties Insurance Buying Guide**
- **Tax Liability Insurance: The Basics**
- **Cyber Liability Insurance Buying Guide**
- **2020 D&O Insurance Trends: A Looking Ahead Guide**

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Back to TOC ›