Transaction activity and the changing risk environment in the last six months has driven demand for bespoke insurance and risk advice both internationally and specifically in relation to product and industry areas. Key highlights include:

- The outcome of the AIFMD and impact on private equity fund professional indemnity cover.
- Downturn increasing claims and demand for warranty insurance in private equity exits and commercial property deals.
- Demand for due diligence advice in developing regions in continental Europe.

### AIFMD - THE NEXT STEP

On 16 November 2011, The European Securities and Markets Authority (ESMA) passed their recommendations on the directive to the commission, and now the next phase begins. It is anticipated that the Commission will produce the final level 2 measures by March 2012 and from July 2013 the directive will become fully operational.

The latest developments are largely positive; ESMA has taken into consideration the concern expressed by the industry respondents in implementing the measures relating to additional own funds and Professional Indemnity Insurance (PII) requirements. This reflects the perceived difficulty for finding capacity within the insurance market to fulfil the previous coverage requirements of the PII cover.

Respondents on the consultation hoped for revised measures for calculating the amounts of additional own funds and the coverage of PII, requesting the option to have a combination of additional own funds and PII instead of one or the other. Industry respondents also sought the calculating of risk to be based on variable assets under management, as there is no logical link between the liability risk and income of an AIFM.

On the whole, ESMA has acknowledged the responses and adapted their recommendations accordingly. They have seen the merit in the option of having a combination of additional own funds and PII, and clarifying that a combination of several PII policies is possible (except in cases where a combination of additional own funds and PII is used, in which case only a single PII policy shall be concluded).

Although ESMA did not agree to exclude losses arising from entities providing services to the AIFM under a delegation, they have clarified that the liability of the AIFM shall be limited to the AIFM’s directors, officers or staff or third parties for whom the AIFM has vicarious liability.

ESMA also retained the rule for calculating additional own funds to cover the potential liability risks which are based on the variable assets under management. This has largely been based on the assumption that risk rises with the value of the portfolio’s of AIF’s managed by the AIFM.
Having reviewed the revised areas to be covered by additional own funds or PII, ESMA has taken into consideration the capacity of the insurance market with regard to PII cover and the potential liabilities that can be covered under an appropriate policy. Some of the areas highlighted included:

- Risk in relation to investors, products & business practices.
- Losses arising from a failure to meet a professional obligation to specific investors and clients. Those risks include:
  i) negligent loss of documents evidencing the title of assets of the AIF
  ii) misrepresentation and misleading statements made to the AIF or its investors by the AIFM or the AIFM’s directors, officers or staff or third parties for whom the AIFM has vicarious liability
  iii) negligent act, errors or omissions by the AIFM resulting in a breach of:
    a. obligations according to law and regulatory framework
    b. duty of skill and care to the AIF when carrying out its professional activities
    c. obligations of confidentiality
    d. AIF rules or instruments of incorporation
    e. terms of its appointment by the AIF (except internally-managed AIFs)
  iv) failure by senior management to establish, implement and maintain appropriate procedures to prevent dishonest, fraudulent or malicious acts by the AIFM’s directors, officers or staff or third parties for whom the AIFM has vicarious liability
  v) improper valuation of assets and the calculation of unit/share prices
- Risks in relation to business disruption, systems failures and process management
- Losses arising from negligent failure, resulting in the disruption of business or system failures from failed transaction processing or process management

The inclusion of the term ‘negligent’ has been built-in to the ESMA recommendation, linking the coverage to PII cover, where before it was far broader and in some parts fell outside the scope of traditional PII exposures. ESMA has removed the need for criminal fraud cover and the requirement for cover to include a “relevant person”, now tying in the AIFMs responsibility to third parties for whom they have vicarious liability.

Regarding the level of cover, ESMA have set out certain minimum coverage requirements. The level of cover under PII in relation to own funds is slightly higher, to factor in the higher legal and contractual uncertainty of an insurance policy. Where the use of several PII policies is implemented, the AIFM must ensure all policies meet the minimum coverage requirements set out.

The PII policy must have an initial term of no less than a year. Policy cover must include the liabilities of the AIFM’s directors, officers or staff or third parties for whom the AIFM has vicarious liability. Any defined excess is to be covered by additional own funds which are to be held in addition to the own fund requirements.

Along with the above financial requirements, an AIFM must ensure their insurer is licensed to transact PII cover and is subject to regulation and ongoing supervision. When using insurers outside the EU, the AIFM must also demonstrate to the authority that those requirements are fulfilled. The insurer must also have sufficient financial strength with regard to claims paying ability.

The provision of PII versus additional own funds offers an AIFM financial flexibility to meet the risk requirements of the directive. In many cases the purchasing of PII is already a regulatory or investor requirement, the directive simply highlights the necessity to have adequate terms and minimum limits of liability within that cover.

FINEX National looks after a number of AIFM clients, many of whom already purchase higher limits of indemnity, higher than those stipulated by ESMA. We are launching a new Private Equity Venture Capital wording for 2012, which will be available from December 2011. The new Willis PEVC wording will include, and in many cases exceed, the latest ESMA requirements for PII cover.

For further information on our wording and services for Private Equity firms please contact your usual Account Executive or Emily Almond, FINEX National, Willis Ltd.

**CAP CRE Event Info**

In September 2011, over 300 of Europe’s top LPs and GPs returned to Le Meridien Beach Plaza in magnificent Monte Carlo for the 11th annual Capital Creation conference, heralded as the biggest and best Capital Creation event yet.

In conjunction with FINEX National, Simon Dodsworth of Willis M&A chaired and Paul Search of Willis Risk & Analytics spoke with other panel members on Value Creation; Understanding value, mitigating risk and optimising returns.

For further information on the event, please see: [www.wbresearch.com/capitalcreationeurope](http://www.wbresearch.com/capitalcreationeurope)
The Willis M&A team have worked with Montagu Private Equity’s investment team in recent years across a number of European investments. With first hand experience of our risk advisory services Montagu approached us regarding a potential acquisition in Poland to conduct a full insurance due diligence exercise.

The deal involved purchasing 100% of the shares of TP Emitel from Telekomunikacja Polska Group which was in turn owned by France Telecom. Emitel is the leading owner and operator of terrestrial TV and radio broadcast infrastructure in Poland. This transaction is the first for Montagu IV (Montagu’s EUR 2.5bn fourth fund) and the first into Poland. It also represents the largest foreign private equity transaction in the CEE with a transaction value of PLN 1,725 million (EUR 425m).

Our engagement was to undertake the insurance due diligence on the Emitel business. As with any transaction important issues can arise, and in this case we identified that the current insurances ceased at completion. Confirming that appropriate cover will be in force is key in a deal situation to ensure risk transfer mechanisms protect the business and that all financial impacts on the business are accounted for as early as possible during the financial modelling. This situation therefore became a dual process in order to identify and find a solution to any historical liabilities, as well as identifying the relevant standalone assets of Emitel, and designing an appropriate insurance programme. Working closely with our Willis colleagues in Warsaw, we were able to provide estimates in order to support Montagu’s bid which then transferred into the successful acquisition.

As with most carve-out situations the insurance programme structure and premium allocations of a large vendor group are not comparable with those of a standalone nature and therefore limits and deductibles needed to be redesigned to a more suitable level. In this case Willis was able to deliver a more appropriate insurance programme with a relatively small increase in premium costs to support the transaction. Our work provided Montagu with certainty of costs and equipped them with an understanding of the business risks. These risks were successfully transferred to the insurance market, providing lenders comfort and ensured an informed investment to take place.

As the Polish economy continues to grow at a rate of around 3.8%, with a particular boom in the Employee Benefits and Construction markets, the requirement for robust risk management is even greater. Willis has recognised this growing demand in Poland and has recently completed an acquisition of its own. In August 2011 Willis Europe B.V. acquired 100% of the shares of the polish insurance broker Brokerskie Centrum Ubezpieczeniowe (AMA) Sp. Zoo. The deal has further strengthened Willis’ presence in the country, adding expertise in the growth sectors. Willis Polska, a wholly owned subsidiary of Willis Europe, has been trading in Poland since 1991 and has 59 employees across three offices in Warsaw, Katowice and Gdansk. By utilising our network and expertise effectively we are able to provide local support and knowledge in the CEE region, whilst capitalising on the M&A specialist focus of our team in London.
In the following section our Transaction Solutions team share the work they have been doing in the CEE.

In addition to this in the past 12 months, the Willis Transactions Solutions Team has successfully placed a number of Warranty & Indemnity policies within the CEE region.

The liquidation of property funds by a private equity seller brought about a need to provide the buyer with a typical set of warranties relating to the target funds and underlying property. As is often the case, the private equity seller was not willing to offer the buyer the level of financial recourse desired and wished to limit their liability for a breach of warranty to a period of six months. Working with the buyer and their deal team, we were able to place buyer-side W&I policies extending the amount and period of recourse available to the buyer thereby satisfying the deal demands of both parties.

Feedback from law firms in Warsaw suggests that going forward, whilst there is still a significant transaction pipeline where W&I insurance may be utilised, the booming Polish capital market of the last few years will start to see a slow down, reflecting the position currently witnessed in the western European and US stock exchanges. As a result, deals currently under negotiation are being accelerated to ensure successful completion.

The overriding feeling amongst M&A practitioners that attended the CEE M&A and Private Equity Forum in Warsaw, appeared to be one of caution, with some even describing the current Eurozone crisis as Europe’s equivalent of Lehman’s. After a robust first half of 2011 the drop off in deal volume during the third quarter illustrates the effect the US and European debt crisis has had on M&A activity in the CEE region and whilst the risk reward profile in Poland remains attractive the challenges are starting to outweigh the opportunities.

Despite this, certain Private Equity (PE) houses expressed their intention to continue their bullish approach to investment in CEE, seizing opportunities created by restructurings that will inevitably follow the current downturn. Other opportunities will be presented by funds coming to the end of their ownership cycle and from retiring owners of family run businesses wishing to sell now, before the economic environment worsens. The unavailability of credit will also mean certain PE houses exiting property based investments to free up capital for reinvestment elsewhere. On a macro-economic level, CEE governments have stated their intention to develop infrastructure to allow capitalism to flourish further and the fight against climate change will lead to increased PE investment into renewable energy projects. 2012 is also expected to see a the continuation of privatisation programs which will offer opportunities to cash rich PE houses under pressure to deploy capital as well as cash rich Asian and Russian buyers entering the CEE marketplace.

MEET THE TEAM

ROSE WEEDON
PROJECT MANAGER

Rose has worked within M&A insurance advisory specialist teams for the past 7 years managing the delivery and presentation of insurance diligence advisory services.

Whilst continuing to work with international clients, Rose takes a specific interest in deals in France where she is able to liaise with clients and other advisors efficiently in both English and French, maximising the use of her linguistic skills which has proved invaluable whilst working to tight timetables. Rose’s experience expands both UK wide and internationally with both private equity and national and multinational corporate entities on all insurance related aspects of their transactions having worked on over 250 deals.

SHASHI INAMDAR
PROJECT MANAGER

Shashi joined the Willis Transaction Solutions team in August 2010, providing guidance to clients on numerous transactions involving a variety of sectors and jurisdictions.

Prior to joining Willis, Shashi spent a year in the HSBC Insurance Brokers Corporate Finance Team as a Project Manager facilitating Mergers & Acquisitions transactions before joining global law firm Reed Smith LLP to train and practice as a Solicitor. He spent the majority of his time in that role advising clients on public and private corporate transactions.
Warranty insurance plays a significant role in the private M&A market. Following the financial crisis of 2008, warranty cover is increasingly used as a tool to ease the flow of capital by de-risking deals, providing great benefits to both buyers and sellers. Indeed, as the health of global economy remains shaky, the demand for warranty cover looks set to become a ‘de facto’ part of any successful transaction.

With private equity funds looking to demonstrate fund performance and realise some of their portfolio investments, Willis estimates that, presently, over 20% of all UK M&A transactions involving private equity exits involve warranty insurance. This is up from less than 10% in 2005. In Europe, a similar pattern is emerging as transactions involving private equity shareholders results in a gap in buyers expectations.

Given the increase in activity, Willis recently talked to Chartis to get an insurers view on whether the economic climate and the increased activity has resulted in an upturn in the levels of claims made against insurance policies.

“The historically, warranty cover was viewed as additional cover in the event of a breach of warranty,” says Andrew Graham of Chartis. That has changed substantially over the past few years. “Now the cover is increasingly bought as a mechanism for deal facilitation and has been used by a number of private equity funds to differentiate their bids in an auction,” he observes.

Broadly speaking, warranty insurance acts as a risk transfer tool that protects buyers and sellers from a breach of warranties and representations when a company is being sold. Understandably, the appetite for warranty cover was at an all-time high in the wake of the global financial crisis. When debt markets seized up, companies looked to insurance as the key to unlocking capital, as well as a method of avoiding complex escrow arrangements. The impact of the crisis on risk attitudes means that warranty insurance remained in high demand even as the economy started to recover. As the very real threat of a double-dip recession looms, and lenders and borrowers start to tense once more, insurers like Chartis anticipate warranty cover will continue to necessitate deal flow.

“The fact is that claims frequency is a lot higher than most companies believed it to be,” says Brindle. The main reasons for notifications not resulting in payment under the policies are; the amounts falling into the retention, the parties settling the dispute, or the underlying warranty having been excluded under the policy.

One reason for the greater frequency of claims is simply that a number of buyers had overpaid for assets before the crisis hit, so 2009 saw a number of buyers trying to offset the impact of under-performing business by making a claim under a Warranty & Indemnity policy. Chartis’ analysis shows that 64% of policies are buyer-side, compared with 56% of claims that are notified.

Because the limitation period for general warranty claims is typically two years; claims on the deals completed in 2008 have filtered through now, as buyers and sellers – but especially buyers – have tried to recover losses made during this period.

“There is no doubt that the deals made in 2008 have given rise to claims,” says Ben Brindle. “The majority of these come from the manufacturing and technology sectors, where a number of deals were overvalued and the business didn’t perform as the buyer had anticipated.”

**WHY BUY M&A WARRANTY INSURANCE?**

According to law firm Norton Rose, there are many reasons why warranty insurance is an attractive proposition for both sellers and buyers:

- The ‘clean exit’
- Disparities between seller and buyer
- Limited seller security or asset backing
- Enhancement of bid proposal
- Protection of family
- Assist to retain seller goodwill
- Distressed sales

For more details, go to www.nortonrose.com and search for “Key issues in insuring an M&A deal”
In a number of cases, Chartis says it is seeing seven figure payouts.

The North American market has also experienced increased claims activity resulting in insurers re-evaluating their underwriting approach. Outside the USA, France has seen the highest claim frequency, followed by Australia and Germany.

Whilst, perhaps not surprisingly, the majority of alleged breaches relate to financial statement warranties, a growing share of claims are filed for alleged environmental violations and tax.

Ben Brindle believes one explanation for this is that environmental legislation is very easy to fall foul of because so many different issues are involved - from pollution to health and safety, and energy efficiency.

Social and governance issues also come into play. Chartis commented, “The financial crisis has undoubtedly led to taxation authorities taking a more aggressive stance in reviewing tax planning schemes and in their approach generally. Each jurisdiction presents different issues and the approach of the tax authorities in new jurisdictions where Chartis is writing business is an important underwriting factor”.

Another reason for the growing interest in M&A warranty cover, is that recognition that the claims process is not as cumbersome as many think.

According to Chartis, their claims team has handled W&I claims in virtually every jurisdiction in which Chartis has issued a policy. In many cases, this is in the local language. The local claims handler, often a lawyer by training, works closely with the local underwriting team and the insured’s lawyers to provide a claims handling process that is tailored to respond to the complexities of any claim.

With the global economic outlook for 2012 increasingly gloomy, there is good reason to believe that demand for warranty insurance will rise accordingly, as companies and markets across the globe look poised to settle into an even more risk-adverse world.