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ATLANTIC GROUP

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INSURANCE-BACKED REVERSE TERMINATION FEES ON M&A TRANSACTIONS

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The M&A market is reacting to changes in risk tolerance for regulatory challenge, driven by a perception that agencies are more fiercely scrutinizing transactions. Buyers find themselves increasingly disadvantaged by increased antitrust risk aversion of sellers, sellers' advisors, and even from their own internal stakeholders. Atlantic can help prospective buyers to level the playing field by proactively offering sellers a reverse termination fee ("**RTF**") backed by insurance in return for a fixed, one-time premium. Priced as a % of a given RTF (which are commonly 3-8% of the enterprise value), the use of an insurance-backed RTF results in an incremental purchase price of 0.15-1.6% of the Enterprise Value in exchange for certainty and participation in an otherwise inaccessible process.

At Atlantic, we're seeking to avoid value being left on the table and to get our clients access to processes by bridging the gap between the perception of antitrust risk held by sellers' and their advisors and actual legal risk of a transaction being blocked, through insurance. As with other M&A-related exposures (i.e., indemnification provisions), RTFs represent a negotiated risk allocation mechanism that need not be borne by the parties to the transaction – it can be synthetically transferred to the insurance market via an insurance policy, allowing buyer and seller to transact based on the inherent merits of the deal itself, rather than the risk of a remote but catastrophic regulatory approval outcome outside of their control.

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Contingent risk insurance can cover the financial consequences of antitrust review

This loss of value to all involved can be avoided by making creative use of the evolving contingent risk insurance market. Insurers underwrite a wide variety of identified legal risks and provide financial certainty to parties that are subject to those risks. The most common application of such policies is coverage for litigation-related risks (such as the risk that a monetary damages award is overturned on appeal or the risk that a defendant will become obliged to pay damages). But Atlantic has also successfully applied contingent risk insurance to antitrust-related exposures - using these insurance policies to indemnify M&A counterparties against the financial consequences of a successful antitrust challenge (including exposure to RTFs, sunk costs, and loss of value post-closing). Atlantic has observed four main risks that parties to transactions are exposed to: execution risk (for the seller), valuation risk (for the buyer), credit risk (for the seller) and timing risk (for the seller). Each of these risks can be mitigated using structured insurance policies.

Execution and Valuation Risk

Issues presented: In a competitive bidding process, buyers whose business overlaps with that of a target company are disfavored by sellers because attracting antitrust scrutiny could lead to a drawn-out deal process, expensive litigation, and ultimately could send the seller back to square one if a court blocks the deal. That uncertainty coupled with the potential waste of time and money often leads a seller to choose an ostensibly less risky bidder, even if the seller will realize less value. Even if buyers are allowed into a competitive process, they may be exposed to risks of a post-closing divestiture (in a forced sale for undervalue), if a regulatory body subsequently challenges the merger ex post facto.

Solution: Insurance-backed RTFs: Same-industry buyers can always level the playing field by offering an RTF – a fee payable by buyer to the seller if a court ultimately rules that the transaction cannot be consummated. But more often than not, this is financially prohibitive – in a fund structure, the buyer may not have the capital available or mandate to put funds at risk of a break fee, and for an RTF to be credible to a seller, the buyer may need to hold aside and pledge liquid assets (or provide an equity commitment letter or fund guarantees) – which may not be economic or operationally feasible. The solution is to borrow the underwriting ability and capital of an insurer by offering the buyer an **insurance-backed RTF** – this gives the seller comfort it needs that (a) it has a promise to be compensated in the unlikely event of a successful antitrust challenge, and (b) that promise is collateralized by a creditworthy, A-rated insurer. This is a win for all involved – sellers have access to a broader market (including buyers who can bid more because of existing synergies), the barriers to buyers accessing prize assets are removed, and insurers can put their underwriting skills and capital to use in a value-generating process. Atlantic would work with buyer to design and secure terms for the policy – it would pay out in the amount of the break fee if the deal is denied such that the break fee becomes due, and this right can be pledged to the seller in support of the RTF obligation. These policies can also, in the right circumstances, indemnify buyer (or seller) for other costs arising from an adverse antitrust outcome such as legal fees and other expenses related to the failed transaction. It can even cover the loss of equity value if a divestiture is forced by a regulator post-consummation of the deal.

Timing Risk

Issues presented: Even for transactions that are very likely to receive court or regulatory approval, that approval may involve seller waiting for a protracted approval processing period. This time delay for monetization may be undesirable or unacceptable to certain sellers, particularly investment funds that need to distribute or re-deploy capital or where there are sales of very attractive assets. Buyers may be in principal willing to advance the funds at the time the purchase is agreed, but this will always create a contingent credit risk for the buyer against the seller if the regulatory process results in a denial and the seller has already distributed or reinvested the funds – and often this will not be a risk buyer can take.

Solution: Insurance-backed prepayment structure. A buyer can put itself in pole position (and exclusivity) by agreeing to pay some or all of the consideration upfront, ahead of the approval being given. Atlantic supports this by making the agreement an **insurance-backed prepayment structure.** The insurers would agree to indemnify the buyer if the regulatory process results in the transaction being blocked, and the seller is unable to repay the already-advanced consideration. We have found this to be an economically attractive solution because insurers can base their risk on both (1) the likelihood of regulatory approval not being received, and (2) the likelihood that the seller is not able to subsequently sell or finance the asset at a value sufficient to repay the proposed buyer in full, with the insurer taking the timing risk after an appropriate period of time.

The same principles apply to litigation outside of a transaction or M&A transactions that require other regulatory approvals

The dynamics described above weigh on transactions that fall into other areas of regulation. Atlantic has experience arranging insurance over RTFs negotiated in connection with CFIUS approvals, which could be extended to ICA approvals, decisions by state regulators in the energy and infrastructure industry, and zoning/ land use outcomes.

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ABOUT ATLANTIC

Atlantic is a specialist insurance broker focused on structuring insurance policies that transfer complex legal, tax and credit risks to the insurance market. More often than not, the insurance solutions are used to facilitate transactions that are impeded by a risk that is dragging on the economic terms (i.e., M&A, financing, distribution, liquidation, restructuring). It specializes in the following products: (i) representations and warranties insurance or RWI; (ii) tax liability insurance; (iii) contingent risk insurance; and (iv) non-payment insurance. Atlantic has 90 people in North America across ten offices, many of which were hired from outside the insurance industry including litigators, M&A attorneys, tax attorneys, structured finance professionals and industry experts.

For more information, please go to: www.atlanticgrp.com