INTRODUCTION

Welcome to the Q1 2015 edition of PE Matters. It is tempting to make predictions at this time of year about the year ahead. This is a pretty risky thing to do at any time but this year seems more difficult than most. Economic uncertainty has been matched by political uncertainty; the UK May General Election threatens to close the IPO market 2 months earlier than normal and the private M&A market will likely slow; in Sweden several sectors are waiting to see the practical impact of the new Government; and the outcome of the Greece’s debt negotiations will be watched with interest in more countries than just Greece. Certainly 2015 will have to compete hard if it is to match 2014, which was a very strong year with over 1800 European deals completed. Of these DLA Piper acted on more than any other law firm for the 5th consecutive year running – which puts us in an unrivalled position to comment on market trends in legal terms (if you would like to receive a copy of the 2014 report when it is published please do register by clicking here).

One area that we can already say has seen enormous growth is the W&I market. Unsurprisingly it seems to be private equity funds which are driving a large part of that growth; depending on the jurisdiction, they are either reluctant or simply will not give warranties. Rowan Bamford of AIG shares his views on page 4.

Continuing on the insurance theme, PK Paran gives his thoughts on private equity transactions in the insurance space and some of the issues that need to be addressed.

Finally, as more private houses look beyond their usual hunting grounds (the US saw Europe as a particularly interesting place to transact in 2014), we are reminded that although it is easy to talk about Europe as a single economic entity, it operates different legal systems. Nothing that makes an otherwise fundamentally good deal a fundamentally bad deal, but nonetheless there are plenty of traps (both value and deal execution) to catch the unwary. My colleagues in France, Germany and the Netherlands share their thoughts. As ever local expert advice, delivered efficiently through a one stop shop, remains key – because as we all know... “everything matters”.

Tim Wright
Partner, Private Equity
Europe
OPPORTUNITIES AND CHALLENGES
FOR PRIVATE EQUITY IN THE INSURANCE SECTOR

Private equity firms are increasingly active participants in the insurance sector, with private equity investment in the EMEA insurance sector at a ten year high. In the past, private equity investment has tended to focus on brokers as they are more likely to offer a quick return and are less exposed to underwriting risk, but there has recently been a marked increase in investment in traditional underwriting business.

NETHERLANDS – Liability for a Portfolio Company’s defaults

Recent ground-breaking examples of the Dutch Competition Authority (ACM) fining private equity firms for their portfolio company’s cartel infringements evidence the need to carry out thorough due diligence and have robust risk controls in place.

Despite the PE firms in question having less than 100% shareholdings (41% and 92%) and no personal involvement in, or knowledge of the cartel arrangements, they were still liable to pay significant fines. The ACM concluded that the PE firms were able to exercise decisive influence over the portfolio company because they had the right to make board nominations, were represented on the supervisory board and were able to block certain strategic decisions. Most PE firms will have a competition compliance program in place for their portfolio companies – but these cases highlight the need to rigorously implement and monitor such programs in order to ensure compliance.

Casper Hamersma Advocate
– Partner Amsterdam
There is certainly a supply of significant investment opportunities in the insurance sector driven by the number of companies actively looking to reorganise their business (with the inevitable consequent divestments) or who require more capital for their existing business. A 2014 Towers Watson report found that 60% of respondents from insurance companies within EMEA expected to divest non-core business before 2017, a significant increase from the 20% of respondents saying the same in 2013.

There are several factors driving insurance companies to divest non-core operations and consolidate their business. Many European insurers have, in response to the impending European Solvency II regulation, divested certain parts of their business in order to simplify their structure and reduce their regulatory capital requirements. Meanwhile internationally active insurance groups and those insurers designated by the FSB as global systemically important insurers (G-SIIs) are being encouraged by enhanced supervision and higher loss absorbency requirements to consolidate and focus on their core business. The impact of regulation has been compounded by consistently low interest rates across many of the major EEA jurisdictions for the past five years. This has squeezed the profit margins of insurers, especially providers of life policies and annuities, resulting in the need to inject more capital into their business or to sell volatile variable annuity business. Finally, there have been a number of state-led sales to re-privatise entities nationalised during the financial crisis or to meet privatisation conditions attached to bailouts received during the crisis (see, for example, the sale of Portuguese insurer Caixa Seguros to Fosun International for $1.36 billion).

Private equity is seen as an important source of funding for those firms seeking capital investment, and many of our clients see private equity firms as a driving force for deal-making going forward. However private equity firms face particular regulatory and structuring hurdles when investing in the insurance sector. Some regulators for instance are wary of private equity investment, particularly in life and other long-term business and need to be guided through the private equity model.

Even the basic economics are more difficult. Careful consideration must be given to the level of debt to be introduced into the target group and the implications that this has under both Solvency I and Solvency II on the group’s regulatory capital resources. The type of instruments also matter as some are treated more favourably than others under regulatory capital rules. Further, debt secured over the shares of a regulated entity or any of its controllers is likely to be expensive as enforcement of the security is not possible without regulatory approval. Finally, the inclusion of certain jurisdictions at certain levels of the structure needs to be carefully thought through in the context of expanding EEA sub-groups for group solvency purposes.

So there is plenty to think about but it is largely surmountable with advanced planning and expert guidance. No one said that private equity was easy and perhaps the absence of the faint-hearted is the final attraction to a sector rich with opportunities.

Prakash (PK) Paran
Head of Insurance Sector, EMEA
Partner

Melanie James
Corporate Insurance Counsel

#1 DLA Piper named European, UK & Global leader by volume of M&A/PE deals completed during 2014 for the fifth consecutive year

Mergermarket

#1 DLA Piper named Insurance Law Firm of the Year

Legal 500 UK Awards 2014

DOING DEALS IN EUROPE: COMMON PITFALL #2

FRANCE – Workers’ right to pre-empt the sale of their company?

Employees should be enabled to make an offer when shareholders intend to sell their company (French Act July 31, 2014 – “Hamon Law”).

It may come as a surprise but since July last year Hamon Law requires smaller and mid-size companies (i.e. those with less than 250 employees) to inform each employee about the intention of its shareholders to sell at least 50% of its share capital or an intention to sell its core business. Such consultation must occur before concluding a sale and in addition to the well-worn path of consulting the works council. As a guideline, two months advance notice should be provided prior to the conclusion of the sale. The ramifications for non-compliance are serious – including the courts declaring the transaction to be null and void.

Xavier Norlain, Partner Paris

DOING DEALS IN EUROPE: COMMON PITFALL #3

GERMANY – Beware of the RETT trap

Most deal-doers will be aware of transfer taxes payable on the transfer of assets. However not everyone is aware that Germany levies real estate transfer tax (RETT) at a rate of up to 6.5% on the value of the real estate even where there is a transfer of a holding company in a different jurisdiction. Recently introduced rules designed to tackle RETT-Blocker strategies highlight the need to ensure robust and well-planned deal structures.

Jan Schinköth, Partner Munich
Q: What is the current state of the M&A W&I insurance Market?

Bamford: 2014 was a record year for the W&I policies. AIG alone underwrote 500 W&I policies – which is 66% up on 2013 and we are budgeting for significant growth in demand again in 2015.

Q: What is the reason behind the increased demand for M&A insurance products?

Bamford: Over the last 5 years, the market for M&A Insurance products has become a lot more sophisticated. Most Underwriting teams are now staffed by experienced corporate lawyers and advisers who are familiar with all types of deal issues/risk and therefore can conduct their underwriting in a way that is much less intrusive from the deal team’s perspective. Most insurers have much bigger teams than they did a few years ago so that the underwriting process can be fast-tracked if required. Most importantly, increased competition has resulted in a reduction in premium rates to a level (usually between 1-2% of the policy limit sought) at which PE buyers now feel that it makes financial sense to buy the product, irrespective of their perception of the risk associated with the deal. It has therefore established itself as a mainstream M&A transactional tool in the UK market and grown hugely in continental Europe with Germany and the Nordics seeing particular increases in usage.

Q: I understand that you are continuing to see strong demand from Private Equity – how is the industry strategically using M&A Insurance?

Bamford: This demand continues to be driven by PE buyers and sellers. On the buyside, PE clients engaged in competitive auctions are using Warranty and Indemnity insurance as a way of sweetening their bids and reducing the amount of recourse demanded of the seller. On the sellside, PE sellers will often be happy to bear the cost of the policy, which can be cheaper than paying Escrow Agent fees and is increasingly seen just as a cost of getting the deal done. Although in the UK PE houses do not give warranties on exit, there are different practices in different jurisdictions. W&I products can therefore help deal with a situation where there is a clash of cultures as it enables the long tail contingent liability owed in respect of the warranties and indemnities given to be ring-fenced and the full sale proceeds to be returned to investors. We are now also seeing an increased take up by trade buyers who are increasingly interested in removing contingent liabilities from their balance sheets.

Q: Does the underwriter’s assessment of the risk differ if the management team are being retained in the Target post acquisition?

Bamford: Management rolling over is often a key driver as to why a PE buyer may wish to put a Warranty and Indemnity policy in place. If management have given warranties on the exit, a PE buyer will not wish to cause disruption in the business by suing its now management team for historical breach of warranty. By putting a policy in place the buyer still has recourse and eliminates the possibility of any future disruption to its relationships with the management team.

Q: Do these products actually work? Will they pay out in the event of a claim?

Bamford: AIG has the biggest M&A book in the market and has been writing this class of business longer than any other market, 18 years. The advantage of this is that we have the largest amount of claims data in the market and have received and paid more claims than anyone else. No underwriter enjoys having claims, but we have been able to demonstrate to the market, by paying out sizeable claims over the last 24 months, that for a valid claim the policy will respond. (We also have 3 claims handlers in the EMEA region well versed in handling complex Warranty and Indemnity disputes).