The Deal Room Podcast

Episode 201 – Protecting Your Sale: Cutting-edge insurance in buying and selling businesses

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Transcript

Joanna:
Hi, it's Joanna Oakey here and welcome back to The Deal Room podcast, a podcast proudly brought to you by our commercial legal practice Aspect Legal. Now, this week we are talking to our expert panel, Meena Wahi of Aspect SME insurance and Angus and Joe who are specialists in Transaction Liability Insurance. Now, we are today digging into a unique insurance product for sellers of businesses and shares in Australia. We also delve into what this insurance is why it is so imperative to now consider in an m&a transaction and how it works in practice. This is a must-listen episode if you are involved at all in business or share sales or acquisitions. So buckle in here we go.

I just wanted to say a massive thank you to coming along Meena, Angus and Joe, I feel like we've got a great panel here for talking about this brand new insurance to Australia. So welcome along.

Angus:
Thanks for joining me, John. Great to be totally all the way from London. But hopefully your listeners will recognize the Australian accent.

Joanna:
You've covered that you're in London very well, we couldn't tell. We wouldn't be able to tell. Now as for Joe, you might be a different story. So maybe it's looking kick it off, perhaps Meena, maybe you and I could just kick it off with a quick discussion about why we find these some this insurance so interested in this type of insurance and why it's so relevant to the Australian market. And then I'll move over to you Angus and Joe to talk about what the product is, and why it's new. But mainly, this is something that you and I have been investigating for a while. And I think, you know, there are so many deals that I'm on, where I can see the benefit in having some sort of protection for the seller and some sort of comfort for the seller in relation to the warranties that they're providing under a sale contract. And what's your, you know, when we started talking about this, you had this great portfolio already of policies that you've been considering? What was your reasoning behind it?

Meena:
Oh, good question, Joanna. You know, at Aspect SME insurance, our endeavour is to help SMEs manage their risk and post COVID though, you know, some might say that this is not yet post-COVID, I got a sense that the market was moving towards rationalization. And SMEs were facing this sort of shift in the market where there was going to be a lot of buying and selling. And in anticipation of, you know, the movement in the market, I went in, I went looking around to you know, what new products will come in, for example, with medical centres, for instance, I realized that telehealth risk could be big. But you know, you and I have been talking about market rationalization and buying and selling our businesses, especially in The Deal Room, it's something that we have been speaking about for a very long time to Aspect Legal. And when I do my research, I always put London and CFC underwriting is one of the most progressive underwriters there. And they had a very good product and transaction liability, it had not been featured. Perhaps it is a new product. So when I did more research, I thought this is great. Like this is a great product for the SME market in Australia, because with buying and selling buyers and sellers are obviously going to feed the need for extra protection through insurance because the warranties and deeds are represented through a sale contract can throw up scenarios where buyers and sellers don't see eye to eye and they can be litigation and litigation is very, very expensive. I think it's a good product.

Joanna:
Yeah, absolutely. This is a great fee for many sellers, I find this concept of the risk that continues post-completion. So you know, they feel like they want to sell their business get off into the sunset clutching their bags of cash, and feel concerned that, you know, they're not going to be able to sleep easy until you know, the warranty periods have expired, so that they, you know, no longer have to be concerned about the risk that follows them. So this is where I'd like to throw to you, Angus and Joe, maybe Can we talk about this product that you have available, which is new to Australia now and I believe more broadly than that a fairly new product for SMEs globally.

Angus:
That's absolutely right. So we launched the product known as Transaction Liability Private Enterprise last year, and we've had a huge response. In particular in the US, we've already bound policies in the Australian market. And we came to this problem with a real SME kind of background at CFC. We started off life as a underwriter about

20 years ago focused on SME cyber insurance, and have really built out a specialty business from there. And one of the unanswered questions when it came to transaction liability, for which we're one of the top five underwriters globally is that there was nothing for SMEs and you picked up on that earlier journey you said that there's a real fear amongst sellers, when they sell their business, that something is going to come out of the woodwork and attack the consideration. And often, you know, they're fun for retirement and have to return some of those proceeds to the buyer, because of there being a warranty breach. And so we thought there is a product out there for much bigger deals, but not for SMEs. So how do we solve that? And we came up with Transaction Liability Private Enterprise. And we knew that there were a variety of things that we had to achieve with it, and I think we've done it. So it's got to be really compelling from a cost standpoint, it's got to be really quick to underwrite. And it's got to be really easy to secure coverage for. So the underwriting process is very streamlined application-based, there are only about 10 or 15 questions that we ask very straightforward. And we can put a policy in place in a shorter timeframe as, as 12 hours, subject to getting all the materials that we need. So, you know, that's the kind of core part of it. And there are all sorts of other benefits that I don't know if you'd be interested in sort of discussing in more detail, but I'll just touch on one of them. And yes, you know, why insurance, which is really what we're talking about transaction liability, private enterprise is the product, the classes, W9 insurance, and W9 insurance. It's not just there to transfer risk. It's there to facilitate deals, it helps people get deals done quicker, and more easily than had they not had insurance. And that's certainly one of the things that we see as being a benefit, especially for Business Brokers, Advisers, not just sellers.

Joanna:
Absolutely, I think you're spot on right there. Because, you know, I talk to business brokers, corporate advisors, accountants, advisors to buyers and sellers who are knee-deep in these transactions on a daily basis. And, you know, there's this constant concern, that when you get into the contract phase, there are all of these issues that arise from when the seller, you know, start to understand the warranties that they're providing and start to understand that they'll that there will be a risk, potentially post transaction or post-completion. And, you know, I think for advisors to be able to have a tool like this, that they can turn to, to be able to then find a way that the parties can get through, to get through these negotiations, really provides a great opportunity. And as you say that it hasn't been available in the SME market. So whilst it's been available in larger transaction sizes, it's the SME market that makes it particularly novel. And I guess it's nice to consider that it's not a novel product, per se, you know that the concept of insurance in this area for larger businesses has been around for a long time. It's the application to SMEs and the ability to make an easier and more cost-effective for SMEs to access this type of insurance that I think is the real and novel element building upon a base of something that has a history of its application in the past for other types of businesses.

Angus:
Absolutely. I mean, it might be interesting to know that Australia is actually one of the most advanced warranties and indemnity insurance markets globally. Adopting the product for pretty much all private equity buyout m&a above, I think it's something like 50 60 million bucks. So it's the way m&a is done in Australia that have bigger deals. I think now with private enterprise, we've got a product which we hope will change the way SME m&a is done to the Australian market or indeed the global market. And you touched on a couple of other points which are probably worth bearing out. So yes, I mean, a seller is usually personally liable for the warranties they give. Now, where it becomes fairly punitive for the seller is if the seller has to give an escrow they have to

put some money from the consideration aside into a separate account that they don't control, which would fund any damages resulting from a breach of warranty or other contractual breaches that locks up that cash they can't get it now, with insurance we've seen especially in the United States, which is quite similar in terms of risk appetite for SME, we've seen that sellers can avoid the need for an escrow by taking out a private enterprise policy and telling the buyer look, I've got this insurance policy. There's therefore covenant strength behind the warranties that I'm giving you. Therefore I don't need an escrow or you know, an escrow's cousin being the whole back which is where the buyer withholds a certain amount of the purchase price for us. Then the amount of time, subject to there'd be no-no warranty breaches. A similar outcome, which is, you know, a bad outcome for the seller, they want to avoid that. And here's a potential solution for them to do. So,

Joanna:
Brilliant, it's such a great idea. And so then, if we can talk about a few areas that have specifics. You talked about it is quick and easy. So we talked about quick, can you said be as short as 12 hours to place a policy? Is that right?

Angus:
Yeah. I mean, all we need is the application, which is 15 questions, or thereabouts, very straightforward. We need if there's a virtual data room, we just need the index of that. Not not, we don't need access to the data and just the index of all the documents that are populated on it. And the agreement that people are wanting to enter into. And that's it. And might be with that, we have a couple of follow up questions. That's, that's pretty rare, you know, honestly, so application virtual index and the agreement, we can quote it, within a couple of hours, we can put a policy in place pretty soon after that.

Joanna:
And what I find interesting is that you don't necessarily even want to get involved in directing the types of warranties that are given is that maybe if you can talk about that a little bit more, and the extent to which the terms of the sale contract will have any impact on the policy?

Angus:
Yeah, so it's a good question. And I think it's worth kind of contrasting it with the main market have bigger deals. On bigger deals, underwriters are very focused on the exact drafting of the warranties, we're not what we're really interested in is finding out what's the likely knowledge of the insured individual that we're insuring under the policy? What did they know about the business? What was their role? How long have they been involved, and we are relying on SME businesses are, broadly speaking, more simple than much bigger multinational businesses. So we'd expect that in the SME context, the owner-manager will have more day to day involvement, and therefore their knowledge is relevant for the warranties they're giving, and the disclosures they will inevitably make, under the terms of the purchase agreement to the buyer. That's the underwriting we're not, you know, we're not hugely interested in in the exact draftee of the warranties, because it's not massively relevant. There are only so many ways you can say the same thing, joining you.

Joanna:
Actually, quite a few ways we can say it. Haha

Angus:
Exactly, exactly. But the essence of it kind of gets the same result. And that's, and that's

what we've concluded. And so, you know, in terms of pricing, okay, the sector will influence the pricing to an extent and the amount of limit that is bought, relative to the total enterprise value, the business being sold is relevant. But as I said, we come back to those three key points that we've tried to have baked into this product design, and that is speed, price and ease. If we don't achieve all three, I don't think we've really got a product that will be attractive to SMEs.

Joanna:
Absolutely, absolutely. And so is so let's talk about price, then you talked about price, can you give a sort of some indication to our listeners approximately how, what the pricing would look like?

Angus:
Sure. So what would recommend in terms of limit and limit will often be the most influential factor for the price? Okay, so we would generally recommend that you buy as much limit as the cap on the intensity that you're giving under the agreement. So let's use some numbers here. Let's say you're selling a business for $10 million, and you've got an indemnity cap of $10 million, well, you should buy $10 million of insurance because that way, you are fully protected against the entire agenda that you're giving. Now, let's take a recruitment business. It's a hot jobs market, I'm sure there's going to be a lot of recruitment businesses wanting to buy SME recruiters because they're doing each business taking that example $10 million enterprise value, they're buying $10 million a limit. You know, I'd be surprised if we can't get that done for you know, anywhere between 50 and 80,000, Aussie dollars for $10 million of limits, you can buy less, and obviously, the price would go down on that basis. And the other thing to bear in mind is that includes the brokerage that we would pay to an insurance broker to place the policy. So that's all included. And there is no underwriting fee which might be an unusual thing to say in the context of commercial SME insurance. I own They say because that's an expected cost. In the main W9 market, you'd have to pay for the premium and you have to pay an underwriting fee to secure wi insurance on those bigger deals. We don't have that on the SME transaction liability private enterprise product, which again, I think greatly assists the overall economics of the product. Right.

Joanna:
And so one of the things that we haven't talked about is that this is a sell-side insurance policy. So this is for sellers. And let's talk about that first. So it's for sellers, why is it for sellers, not for buyers?

Angus:
I think the key reason is that it comes back to the point of knowledge and trying to adhere to those three principles, speed, price ease, if returning the buyer, then we have to try and figure out as underwriters, what's the buyer done? What does the buyer know? And what diligence have they done, and then try and reconcile all of that back to the warranties that they're negotiating? Because the buyer, it's buying business subject to what the seller is telling them. And so you know, the outcome of all that is, it's a far more involved, long and expensive process. Now, we can do that, but you don't get the benefits that we're trying to achieve of speed, price and ease. So sell side, we're capturing that knowledge, the sellers involved in the business, that's really what we're focused on. And that allows us to put those policies in place so quickly with a really efficient underwriting process.

Joanna:
And I wanted to point out that it was sell side, you know, for that educational component

for our listeners. But on the flip side, you know, obviously there is a benefit to buyers in the sellers in their deal sitting across the the other side of the table, from taking out this insurance, you know, it makes negotiation easier, it makes the sellers less nervous. Quite often we find sellers can hit this point where they suddenly realize they're selling their business baby, and they're having all sorts of issues going on that might that might create a bit of a barrier to the transaction anyway, when you add the concern about risk of warranties in there, suddenly you have the risks of deals falling over. And I've certainly seen that quite a few times in the past. So from a buyer's perspective, that I think and I'd be interested in your take on this. But my my personal perception is that there's a lot of benefit for buyers, in in the sellers on the other side of the table, taking out this insurance. What's your Do you have any thoughts on all of that?

Angus:
Yeah, I mean, absolutely, I think. So. It's multifaceted. As a buyer, what are you concerned about? I mean, there's no point of getting warranties in the first place, if you don't have any confidence that there's financial strength to be behind them to actually pay a warranty breach. And now, if you're dealing with a seller, without an Escrow, that say, they're probably going to be dispersing that consideration into a entity or an individual, which is outside of the net, in which they can claim recourse against with an insurance policy, you know, that there is a a covenant strength or a backstop that sits behind the warranties, because the seller is indemnified themselves by an insurance company, which obviously has financial rating, and all the other things that go with that. So it improves confidence in your ability to rely on the warranties being given by the setup. That's from the buyers perspective, you can save on the negotiation time and cost. Because what you could do is you could say, here are the warranties that we'd like, maybe the buyer wants to fund the premium themselves for the seller. And they say, you know, we're going to buy you an insurance policy, you are protected. And here are the warranties that would lie, please disclose against them. But let's cut out all the apologies. If this. If this means you do you have to do less work on an m&a deal. But it should make a deal far quicker. Because negotiation is far more simple. Oh, look.

Joanna:
And you know, that's why I love the idea of this sort of policy, because, you know, we're all about making transactions easier. We don't want to create more work for ourselves, we, we want transactions to speed through and everyone to be happy at the end of the day. And I just think this is such a great way to get over some of the road humps that appear along the way. In a deal. Maybe you can we talk about some stories. I'd love to hear maybe any stories that you've had, where you've placed this sort of policy in a transaction that maybe you've been having difficulties without the policy, what does that look like? Maybe if you can give us some idea of you know, you're on the ground knowledge of how it actually works.

Angus:
Yeah, I mean, I guess the first point I'd make is, you know just how diverse In the SME market is in terms of sectors, types of deals, types of investments getting made. First and foremost, we created this product for the classic conception of SME. So you've got a business person that's selling a fencing business, which we've insured before in the US as an example. They hadn't heard of this, this, this product. And in fact, the reason why this was attracted to the sellers in that regard was the seller said to their insurance broker, why don't I just buy Dino runoff in the belief that Dino run-off insurance would protect them against a breach of warranty under the agreement, it's not the case, because Dino, as the standard has a contractual liability exclusion, which means DNO runoff, serves no cover for the warranties that you're giving, by way of a purchase

agreement. So that was the kind of a cause that got them interested in private enterprise in that context. We've had other scenarios. So we've done a Software Asset deal. And perhaps this is kind of more unique to the US than it is elsewhere. But, you know, Silicon Valley deal, it was a software asset that he sold out of a business that hadn't really succeeded. But the software asset itself was still valuable, they wanted to sell the asset, the buyer wanted some protections against the fact that, you know, the IP that led into the software was actually owned by the seller, and that they could, they could transfer that IP along with the asset that they were selling. So that was another example where, you know, we got a deal done, like period, it wouldn't have happened on this, there was insurance in place because without it, the buyer just never would have got comfortable because the seller wasn't going to be getting reps, or warranties as it would be for Australia, in respect of that asset because the business it ultimately failed. Some other examples we've had your classic kind of fast-casual restaurant chain, as it's become known, like your Zambrero is, let's say, in Sydney, or your Madmax, you know that that kind of fast-casual chain in Southwest US where the seller didn't want to give an escrow. And the buyer accepted the insurance as a replacement for the escrow. So, you know, that wasn't just a benefit for the seller in facilitating a deal. But it was a real economic benefit. Because if you have a portion of the proceeds tied up in an escrow that's costing you money, there's an opportunity cost that that opportunity costs in that instance, was actually greater than the cost of insurance. So they had more protection in terms of how much limit they bought. And besides the indemnity. So the buyer was happy, the seller was protected. And it was actually saving the money because they didn't have to buy the escrow or pay for the escrow. So there are just some examples of how it's used. And I would say this, that, you know, insurance is typically thought about as a risk transfer, kind of policy, or risk transfer instrument. And what I mean by that is, you buy property insurance, to protect against your house burning down, but you don't expect your house to burn down. But if it did, you're covered great transaction overly private enterprise protects you against the house burning down by analogy, but it's also a really great deal facilitator, I touched on this earlier, but if you use it strategically, in a way that is going to save you time on on negotiated warranties, you're going to be able to get it a deal done quicker, and you're going to get a buyer to pay you more because they've got more warranty protection. Well, you're so far ahead of what you would be absent insurance.

Joanna:
Absolutely, absolutely. And we have a lot of business brokers and advisors who listened to this podcast, and it just, you know, these seedings, my days here, you know, the things that I'm thinking about, you know, if you bake these into a deal, so you have your sellers, starting out in the negotiation of the commercial terms, thinking about being able to use these type of insurance, and then the buyer comes on board, you know, having priced the deal with this understanding that the transaction could be quicker, smoother, and give them more protection at the end of the day for the asset they've purchased because you know, the warranties will be more robust than they would have been otherwise. You know, I can see how this could really facilitate a great discussion point right in the beginning and I guess timing is quite important here. Although as you said, we can place the deals very quickly. So there we go.

Angus:
Not only that but so there are three kinds of points of purchase you can engage with the process before you sign a deal. You can sign a deal. And in between signing and completion of the transaction, you can then secure insurance and you can even secure insurance off To the transaction completes, if you wish, I would really recommend that insurance is bought. Or at least you start the process precisely because that's where

you get that deal facilitation benefit that was spoken about.

Joanna:
Yeah, yeah. Yeah, absolutely. And I just wanted to talk about the deal sizes that this relates to, and I just want to bust the myths that might be out there for some of our listeners listening in thinking that this might only be for the 10 million-plus deal size. What sort of, you know, sales sizes? Can we be looking at where we can utilize these types of insurance?

Angus:
Yeah, I mean, it's a good question. And we definitely cater for the s in SME, so we can go down to 250,000, even less. I mean, now, you know that the range is sort of, you know, we say 250. And for the Aussie market, it's up to circa 30 mils. In enterprise value, these aren't absolute hard numbers, there's flex there, you know, we're not going to say no, if it's a great deal, to ensure if the deal is, say 200,000, Ozzy. But, you know, I think everyone will admit that for, for a deal that that size, it probably wouldn't really be a common deal in the business broker, network. But look, we're open to it. And if there are deals out there that that at that size, and would absolutely consider it.

Joanna:
Brilliant. Okay, well, look, I think we've covered it all. What a great product. I think that, this is something that will get a lot of traction here in Australia, I'm really excited. I love innovative new things that I really super love, any sort of tool that we can use to make transactions easier, quicker, and smoother to get through the whole process. So look, I just want to say a massive thank you to all three of you for coming along any parting words,

Angus:
thanks so much for inviting us on. And I think we're just so excited to kind of have a product for SME, which takes us back to CFCs roots. And Australia is one of the only five markets that we're offering this product in. And it is the only sell-side SME m&a product available anywhere. So for the business brokers out there, lawyers focus on SME transactions, you know, please feel free to get in touch with with you or with us and would gladly have a conversation because we're making a market here and we want it to be really relevant to Ozzie SMEs. And, and we kind of do that by starting that conversation. So hopefully, hopefully, we've got a flurry of emails and stop.

Joanna:
Brilliant and Joe do you have any parting words from your side.

Joe:
Oh, I was just gonna say read that Gus has done a brilliant job in explaining the product. Why I've kind of been on the ground with this with Gus, kind of since the inception of the products. And I'd really just echo what he said in terms of how quick this product is in place, how easy it is, and how cheap is kind of compared to the standard. We've already placed dozens of these policies now across quite a few jurisdictions. And we're also in the process of building out the team specifically for this product. We've got two specific underwriters for the product with one to come as well. And Gus is obviously heading up the team as well.

Joanna:
Brilliant. Wonderful. Okay, great. Thanks, Joanne Mina, any last parting words from you?

Meena:
I can only say to another it's, you know, a great product and the satisfaction that comes with serving your clients and anticipating the needs and providing them with the right product at the right price. That's what it's all about. So I think we've lined up on the key elements of having a product that's going to be of great value to clients. And that's what it's all about.

Joanna:
Absolutely. Absolutely it is. Well, look. Thank you all three of you for coming along. We'll put details in our show notes of how you can contact Meena at aspect SMA insurance. If you're interested in finding out more about these whether or not you're a seller or an advisor for buyers and sellers in this market.

Well, that's it for this episode all about Transaction Liability Insurance. I hope you enjoyed our podcast today with our amazing expert panel as we dug into this innovative new insurance product in the SME m&a space. Now, if you're interested in finding out more about this product, we have a webinar coming up very soon now you'll find the details for that in the show notes. And if you missed the webinar for this because you're listening to this podcast at some point in the future after the webinar has been held, then have no fear, we will have a replay available for you as well. And you'll once again, find those details in the show notes. And if you'd like to talk to Mina about getting some of that insurance in place or understanding the relevance of how you can get insurance in place in your deals, then just check out our show notes as well and we will link straight through to Meena where you can set up a discussion and get started with some of the benefits of this insurance in your deals. Well that's it I hope you enjoyed what you heard today. If you did please subscribe to The Deal Room Podcast on iTunes or on your favourite podcast player to get notifications straight to your phone whenever a new episode is out. We'd also love to hear your feedback so please leave us a review in writing if you're already one of our subscribers or even if you're listening to this podcast for the first time Well thanks again for listening in. This has been Joanna Oakey and The Deal Room Podcast a podcast proudly brought to you by our commercial legal practice Aspect Legal. See you next time.