Mergers and Acquisitions

Litigation Buy-Out Insurance

Litigation Buy-Out Insurance (“LBI”) is a tailored insurance strategy from AIG’s Mergers & Acquisitions team that isolates a client from the uncertainties inherent in outstanding litigation; whether they relate to the outcome or the eventual amount of damages awarded. Each policy will cap an insured’s exposure or remove it altogether and will be crafted to meet the particular needs of the insured and the specific characteristics of the dispute.

Cover

Litigation Buy-Out Insurance enables a client to ring-fence liabilities which may arise from any current or anticipated litigation, arbitration or other dispute. This is particularly useful in the context of a sale of a business where the unresolved dispute would otherwise prevent the sale proceeding or would have a significant impact on the price to be paid. Insurance takes this uncertain liability out of the negotiations, allowing the parties to concentrate on the business itself.

As underwriting and cover are customised in each case, the policy can be tailored to a dispute, irrespective of its subject matter. Consequently the insurance may cover all proceedings from a simple breach of supply contract, a more complicated employment issue through to highly complex securities litigation and intellectual property disputes.

Policy Form

LBI is typically underwritten to cover a single specific known risk, lawsuit or claim but may also allow for threatened litigation or an anticipated claim. The insured may choose to have defence costs included in the limit of liability or simply to cover the amount of any award of damages. LBI can also be provided to cover groups of claims or lawsuits (sometimes known as “loss portfolio transfers”), such as for multiple employee claims or product liability suits.

- Policy Period - The policy term will usually run from the transaction closing date or other specified event date until settlement or final adjudication of the dispute being covered.
- Retention - The insurer and insured will agree on the “retention” or excess, which is the uninsured amount of the loss to be borne by the insured. The higher the retention, the lower the insurance premium will be. In some cases the retention will correspond to the amount of cover available to the insured under an existing insurance policy from another insurer, in other cases the retention will be borne by the insured directly.
- Exclusions - As LBI cover is tailor-made for each situation, cover will vary from policy to policy but will generally exclude fines and penalties, acts committed by the insured with the intent of violating any law and pension funding deficits.

Underwriting considerations

AIG will consider offering insurance in respect of all litigation risks in which there are good prospects of a favourable outcome. Even where an adverse outcome is predicted, insurance may be available, but the premium will take into account the amount of damages and costs that are likely to be awarded. The timescale for obtaining LBI will depend on the stage reached in the dispute, but will usually be available within 2 to 3 weeks from first enquiry.

Limit

£2.5m to £15m aggregate limit of liability for any one LBI policy.

Strategic Benefits

- Transfers an uncertain liability from the insured to the insurer. Reduces the insured’s concerns about conduct of the litigation or its outcome
- Transforms contingent third-party claims into a quantified insurance cost allowing them to be precisely accounted for
- Caps future financial risk: the premium is fixed and paid, irrespective of the outcome of the dispute
- Releases business opportunities previously blocked by claims or disputes
- Eliminates obstacles in the way of a pending sale or acquisition
- May enable favourable public disclosures, subject to insurer’s agreement

In the event of a claim, AIG has an in-house team of claims professionals dedicated to transactional insurance. These seasoned experts specialise in disputes surrounding complex transactions and in processing claims professionally, swiftly and expediently.

Premium

Given the bespoke nature of the product, the policy premium will vary widely from case to case. Premiums for policies have, in the past, been as low as 5% of the limit of liability purchased. At the other end of the scale, where an adverse outcome was expected, the premiums have been as high as 50% of the policy limit.

Case Studies

- Securities Litigation - As a result of accounting irregularities, a public company restated its accounts. The share price declined, triggering shareholder lawsuits. The company's reputation, market capitalisation, financial condition and employee morale all suffered. Worse still, a planned sale of the business was postponed due to the ongoing litigation.

  The company purchased LBI, which transferred the litigation liability to the insurer. With this liability addressed, the company was able to focus on finalising the sale and (with the insurer's consent) publicly disclose that insurance was now in place. This helped to reduce uncertainty over the company's financial condition, increase the company's share price and ultimately its sale value.

- Uninsured event - A private equity firm, unhappy with the management of one of its portfolio companies, sent letters threatening litigation in order to oust the current board of directors. The private equity firm alleged that the board had breached its fiduciary duties resulting in a $63m investment loss to the private equity firm. On receipt of the threatening letters, the company made a claim under its Directors & Officers Liability Insurance policy; that claim was declined. As a result of the threatened litigation and the absence of D&O cover, the company's independent directors threatened to resign their positions.

  Instead the company obtained LBI insurance, providing it with a two year option to purchase a $5m policy covering costs to defend the claims and any ultimate award of damages, with no retention. With that option in place, the independent directors agreed to remain on the company's board.

- Under-insured liability - The owners of a business were keen to sell their holdings to a private equity firm but the buyer was concerned about significant unknown liabilities which might arise from pending product liability lawsuits. The potential buyer would proceed with the purchase only if a significant discount, based on its worst-case estimate of the liability, was applied to the purchase price.

  The seller considered the buyer's estimate to be too pessimistic, so instead sought an insurance solution. This was a $40m Catastrophic Equity Protection Policy, excess of existing insurance, to assume responsibility for conduct and settlement of the litigation, including any damages awarded. This effectively took the litigation concern out of the transaction, allowing the seller to conclude the sale of the business for its full value.

- Employee disputes - A private company was approached by a competitor keen to acquire them. Heads of terms were agreed but there was one obstacle to agreeing a sale: a former director who had been dismissed had made vague threats that he would sue. The potential acquirer would not agree the sale price until that issue was resolved.

  The company arranged LBI of £3m to cover any litigation or proceedings the director might bring. The sale was now able to proceed at a price acceptable to both sides.

These scenarios show the potential applications and possible scope of LBI. Note that they are illustrative only and not to be relied on to justify coverage in any particular situation.

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