Covering All Bases

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One of the main types of insurance private equity houses will look at is that covering management liability, typically covered by directors and officers' insurance (D&O). D&O covers any individuals with a board seat on any of their portfolio companies. As board members, these individuals' fiduciary duty is to act in the best interests of the company. A common issue is one in which someone questions whether a private equity house representative has made a decision that benefits the private equity firm rather than the portfolio company. D&O also covers other liabilities associated with being a company director, such as an instance in which board members are sued in the event of an environmental problem.

Professional liability (PI) insurance is another standard product for private equity. It insures professionals in a firm against potential litigation surrounding investment decisions, for example. It would cover claims against a firm or individuals in a firm for action from limited partners, syndicate partners, banks and other institutions lending to portfolio companies, minority shareholders of portfolio companies, management teams and buyers of an investee company.

It is now possible to buy PI as a blended product with D&O and this makes it simpler to arrange cover as you only need to go to one insurer and explain your needs. But it also prevents the situation in which two different insurers argue over which policy a particular claim falls under; relatively commonplace because of the similarities of cover between professional liability and D&O.

Howden's, a broker selling management liability products mainly to UK private equity houses, is seeing increased interest from other parts of the world. "We have opened an office in Mumbai," says Howden's Rupert McLean. "Our clients in India are looking to source insurance here in London because they are seeking investors from the UK."

Other regions are also starting to look at this type of insurance. Insurance in the Middle East, for example, is beginning to take hold. "The insurance market here is reaching early adulthood," explains Ian Sangster, CEO of Qatari insurance company QIC International. "It has historically been driven by fairly basic products, such as fire and peril policies for property and car insurance, but with the advent of large project finance deals and the development of the stock markets, other products designed to improve risk management are starting to emerge. D&O insurance is an emerging market here."

"It's still a relatively young market," adds Sangster. "The international companies that come here have D&O anyway, but local companies are starting to have it as the philosophy of risk management starts to develop."

Regulation is one of the strongest drivers for insurance in the region. "The market here is so fast moving that the approach to risk transfer is more traditional and less sophisticated than much of the rest of the world," says Tim Davies, director, MENA at AON. "Dubai is becoming the fourth global financial hub and in many ways, it can live up to that name, but the purchase of typical management liability policies, such as directors' and officers' liability and professional indemnity, tends to be driven by regulatory compliance and corporate governance rather than a considered risk management philosophy. This is not, yet, a litigious environment. There is still a lot of education to be done as far as insurance is concerned, as the attitude towards risk tends to be fatalistic. Managing risk tends not to be high up the agenda."

Yet even in what are often considered more developed emerging markets, there is still scope for increasing the market for management liability products. Central and Eastern Europe still lags the west to quite a degree in this area. "There is room for growth on products such as D&O, business interruption, etc," says Christoph von Lehmann, client director CEE at AON. "Some companies are not insured adequately and have low liability limits."

The other category of insurance products for private equity houses covers the risks surrounding transactions. The most commonly – used of these is representation and warranty (or warranty and indemnity) insurance. Relatively new even in the UK and the US, these products generally replace the need for warranties and can therefore be used to strategic advantage in securing deals where competition is high. Tax opinion insurance is another popular product.

These types of product are witnessing rapid growth in a number of regions, according to John McNally, head of international M&A practice at AIG UK. "Over the last 18 months, transaction insurance products have started to take off in regions they weren't seen in before," he says. "Previously, we had written products in more established markets such as China, Japan and Central and Eastern Europe, but now there's a lot more business coming from Southeast Asia, India,

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Latin America and the Middle East than we've ever seen before. We're writing products in all the centres of deal activity that have emerged over recent times."

Much of this demand is driven by the increasing focus of international private equity houses on emerging markets as deal competition has intensified and the availability of debt has dried up in the US and Western Europe. "The international funds are used to using these products in their traditional markets," says McNally. "Now they have an increasingly global appetite, and they are doing the same in emerging markets."

But the reverse flow of capital is also creating demand for products on the basis that investors want to feel comfortable about the risks they are exposed to in unfamiliar markets. "One of the biggest trends we're seeing at the moment is the huge amount of capital being invested in the US and Western Europe by Middle Eastern and Asian investors," says McNally. "This presents a great deal of potential for insurance products. Just as Western investors may have concerns about the legal risk in emerging markets, so we're seeing companies and investors from markets such as India using M&A insurance products for their acquisitions in the US or Western Europe."

As emerging markets develop and broaden competition for deals will boost demand for transaction insurance products. Transaction insurance is often used in Western markets to smooth transactions and gives as warranties and indemnities insurance negates the need for holding large amounts (typically 10-20%) in escrow thereby removing blocks that might otherwise cause deals to falter. "We're now at a point where private equity in many emerging markets is moving beyond the usual starting point of venture and expansion capital to buyouts," says McNally. "Some are also at a point where private equity houses are ready to sell their holdings and as a result are bringing in insurance products as a means of smoothing the sale and removing the need for escrow arrangements."

Davies believes this could happen in the Middle East. "Private equity funds understand the concept and availability of the different types of transaction insurance products, such as warranty and indemnity, tax opinion liability, etc, but it hasn't taken off in a big way," he says. "This is possibly because the private equity market is at a nascent stage where funds tend to take minority interests rather than controlling, majority stakes in leveraged buyouts and so insurance may not always be appropriate. As the market develops, particularly towards larger buyouts, this will undoubtedly develop."

But it is as much about education as it is about sales, adds Davies. "We are working to create demand for insurance products in MENA," says Davies. "We placed one large warranty and indemnity policy last year in Saudi Arabia, for a cautious investor, new to the region. I think that as more international investors and professionals start coming to the region, their practices, including the use of insurance solutions for complex transactions and portfolio arrangements, will spread and demand will increase."

As local firms become more familiar with the kinds of insurance product on the market, there is scope for further development. "While much of the insurance market has centred on the international firms, it could well filter through to the local firms; we've just covered a deal in Argentina involving a Latin American fund and we're increasingly seeing local firms in Central and Eastern Europe use these products," says McNally.

It is a trend noted by von Lehmann: "Poland is the main market here in CEE and that's where we have headquarters, but we have a presence in all CEE countries and are actively looking at the up and coming markets of Romania and Ukraine. We're also seeing increased demand in Turkey." While some firms attempt to get around the issue of escrows by switching from share deals to asset deals or through earn-outs, insurance take-up is on the rise. "There is a very high demand here for warranties and indemnities," says von Lehmann. "Almost 90% of deals here have some form of escrow account arrangement, so firms that can circumvent this and allow owners to exit more cleanly, will be at an advantage."

The other factor in this is the price of premiums. Even if some of the local firms may have been interested in insurance in the past, they may have felt the cost was prohibitive. While the premium is deal-specific, varying according to the risk factors in different sectors and the quality of the due diligence, there is no doubt costs have come down on a general level, making insurance products a more affordable option in some regions. "Pricing has fallen significantly for warranty and indemnity policies," says von Lehmann. "That is in some part to do with increasing capacity and competition, but it's also because there have not been many claims and, importantly, because due diligence has improved so much that the risks are now much lower than they were before." The other factor is how well insurers know a market. "As we become more familiar with different regions and understand the risk profiles better, that will have an effect on the premiums we charge," says McNally.

So how are the insurers and brokers catering for the increased demand? The shift of the global economy towards more emerging markets inevitably means more new offices or increased headcount in some of the key markets. Howden's move into India is a case in point; the firm sent out two of its private equity specialists to establish the new Mumbai office. For

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AIG UK, it means making use of the AIG International network in 130 countries, says McNally. "We don't have M&A people in every office and we still do a lot of work from London, but we will reach a point where we need to put more specialist M&A people on the ground," he says.

The market is clearly growing, yet there is still some way to go before the full suite of insurance products is offered across the globe. Africa (with the exception of South Africa) has yet to make onto insurers' radars and Russia is a difficult market to get to grips with, say the experts. There are also certain types of insurance that are just not yet feasible in some markets. Tax opinion insurance is hard to get in Central and Eastern Europe because of uncertainty surrounding historic liabilities, for example. But as private equity deal-doing becomes more entrenched and a greater focus on corporate governance takes hold in many of these economies, insurance products seem bound to follow suit.

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