



Contingent Risk Insurance: A new insurance market for known legal risks

Introductory Report

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Gallagher

Insurance | Risk Management | Consulting

What is Contingent Risk Insurance?

Gallagher is helping clients to unlock value and unblock deals by insuring contingent risks through its growing Contingent Risk Insurance marketplace.

A contingent risk is any known legal risk that could have a negative impact on a company or asset's value.

There are three elements:



Contingent Risk Insurance (CRI) is mainly used in a transactional context, but Gallagher can also help with special situations such as disputes, liquidations and shoring up balance sheets.

Why use Contingent Risk Insurance?

The Contingent Risk Insurance market can be the most appropriate carrier for low probability high value exposures because you can access a much larger indemnity limit and achieve complete risk transfer without tying up capital (escrow, indemnity or parent guarantee) or paying high rates for third party security.

Driven by private equity investors, the CRI market has allowed for creative balance sheet management in order to access capital, lending and higher valuations. Funds and companies are reducing administrative costs by quickly winding up portfolio companies or preparing targets for sale by packaging known risks into CRI programmes.

Public corporates are also waking up to the benefits of insuring against known, uncertain legal risks, allowing CRI to feature in securities offering documents as a way of enhancing and underpinning value.

Example Situations



Distressed acquisitions: insurance for seller indemnities, title to assets, transaction at undervalue and known or unknown third party claims.

Voluntary winding up: to reduce administrative costs and distribute proceeds (insurance for third party claims).

Insolvency winding up: insurance for the sale of assets, closing out the company's financial positions and resolving claims made against the company. Protects creditors, administrators, trustees and insolvency practitioners.

Management buy-out: protection for management and/or sponsors for known contractual or IP breaches and third party claims.

Investment in real estate, renewables and infrastructure: protection against known title disputes, missing permits, availability of subsidies and feed-in tariffs.

Public offerings: removing balance sheet provisions such as litigation and tax exposures.

Public to private acquisitions: insuring key exposures in absence of a warranty/disclosure process such as title to IP, breach of licence, missing title documentation, tax risks and litigation risks.

M&A: known issues excluded from W&I cover, traditionally indemnified by seller, such as breach of contract, defective title and known disputes.

Lending: uncertain events causing borrower default under loan documents.

Historic and pre-sale restructurings: non-tax exposures relating to debt restructuring and company restructuring.

Liquidity requirements and capital relief: reducing or removing balance sheet provisions such as third party claims and preservation of settlements.

Synthetic W&I: cover for certain known and unknown exposures (absent counterparty covenant strength or seller warranties) including IP, litigation and title to assets.

Alternative collateral: a form of security for any contractual obligation including contractual indemnities.

Market outlook

The beginnings of a Contingent Risk Insurance market

Until recently, the market for Contingent Risk Insurance was only a handful of underwriters, dominated by company markets and Lloyd's syndicates. Navigating the market involved not only Transactional Risk Insurance teams but also management liability, professional indemnity and other insurers.

Over the last three years, the transactional risk market has developed a growing appetite for contingent risks. This was initially borne out of enquiries arising from corporate mergers and acquisitions (M&A) (similar to the Tax Insurance market).

In 2019, the number of transactional risk markets increased to nearly thirty, dominated by Managing General Agents (MGAs) who underwrite and issue policies on behalf of insurance companies and Lloyd's syndicates. This led to increased competition and downward pressure on rates for Warranty and Indemnity (W&I), Representation and Warranty (R&W) and Tax Insurance.

Driven by a growing number of contingent risk enquiries, more transactional risk underwriters have started to look seriously beyond W&I/R&W and Tax Insurance to assist their clients, and to access alternative income and higher premium rates.

In 2020 we are now seeing a combined effort across the transactional risks space to create a CRI market. Underwriting teams have increased their appetite and underwriting authority by hiring accountants, solicitors and specialists in litigation, Intellectual Property (IP), insolvency, and corporate restructuring.

Over the next few months, the ongoing downturn in M&A deals will allow more Transactional Risk Insurance teams the time and impetus to explore contingent legal risks.

The combination of increased expertise and focus on contingent risks means the Transactional Risk Insurance market is fast becoming the dominant home for contingent risks.

Over 10 markets and GBP1bn capacity

Gallagher now has access to over eighteen markets across Europe and the US writing Contingent Risk Insurance policies, the majority being MGAs - with nearly all of them originating in Transactional Risk Insurance. In 2020 we estimate there could be up to GBP1bn capacity for any one risk.

Insurers have seen a twofold increase in the number of CRI enquiries over the last six months, from an average of five per month, to at least ten.





Policy requirements and pricing

Submission Requirements

- **Quantum:** the highest potential liability and how this quantum was reached.
- **Access to information:** each risk is underwritten based on the underlying facts.

Whilst legal and expert opinions are helpful, underwriters will carry out their own analysis of the underlying facts.

How do underwriters price the risk?

In order to consider the price and insurability of a contingent risk, underwriters look at the following:

- Analysis of the likelihood of a triggering event
- Overall quantum of likely and worst case scenarios
- Analysis of mitigating factors (such as a legal defence)
- Competition from the wider insurance market and alternative sources

The most important pricing factor is competition, as experts' opinions and underwriting experience can vary significantly for highly bespoke contingent risks. The key driver for competition is a broker that can efficiently generate arbitrage opportunities within and beyond the transactional risk market.

Typical policy terms

The rate on line for CRI varies on the type of risk, size and availability of information. As a general rule the following rates apply (as a percentage of limit purchased).

LOW RISK OR SINGLE ISSUE	2 - 10%
MEDIUM RISK OR MULTIPLE ISSUES	5 - 10%
COMPLEX RISKS	10% and above

Questions you need to ask if you're a...

Finance director

- Can insurance be used to clear balance sheet provisions and reduce spend on dormant corporate vehicles?

General counsel

- Is there existing litigation that is preventing a sale, investment or access to debt that can be de-risked?

Buyer or seller (distressed or special situations)

- Is there a potential sale at an undervalue, are there creditor risks arising from a pre-sale restructuring; can you ring fence known title risks (real property and IP)?
- Is the seller unable to give and/or secure warranties and indemnities?

Fund (GPs and LPs)

- Is the fund at the end of its life with not enough time to fully resolve outstanding contingencies, before required distributions?
- Are there legal risks affecting liquidity?
- Have you considered insurance collateral for historic liabilities/indemnities?

Private equity investor

- Have you considered insurance for balance sheet provisions, third party disputes, employee litigation, TUPE exposure, IP breaches or other liabilities affecting the target and/or management?

Investment bank

- Are you effectively advising your client of ways to ring-fence liabilities in preparation for a transaction?
- Is there a potential break-fee exposure owing to regulatory approval?

Legal adviser

- Are there flagged issues in due diligence, W&I policy exclusions, "uninsurable" tax matters, secondary liabilities, existing litigation (title, IP, employment, multiple settlements) that could be passed on to the insurance market?

Insurance firm or pension fund

- Have you reduced theoretical exposure to large potential claims or litigation
- Have you effectively managed balance sheet issues, are some funds affected by missing clients and beneficiaries?

Public to private buyer

- Seller warranties and synthetic W&I cover is not always available, could your main concerns (known and unknown IP breaches, disputes, legal title defects) be ring-fenced by insurance?

Lender

- Is there a known legal risk potentially affecting your borrower's credit rating?
- Is your borrower unable to fully insure their underlying asset?
- Could you look to the insurance market as alternative protection for loans?

Case studies

Ongoing third party litigation

Situation:

Acquisition of a pharmaceuticals business. Target named as a party to ongoing third party litigation.

Problem:

Potential costs and damages relating to the litigation represented 10% of deal value. Seller willing to offer indemnity but unable to provide collateral via escrow or parent company guarantee.

Solution:

Collateral for indemnity provided by way of a litigation buy-out insurance policy in the name of the target. Cover for damages, costs awards and legal expenses relating to the ongoing litigation. Seller allowed to distribute funds and buyer had direct access to policy proceeds in the event of an adverse court decision.

Breach of contract / licence

Situation:

Technology business preparing for management buyout.

Problem:

To execute the buyout, management required an indemnity from exiting shareholder for any losses arising from an historic breach of licence. Issue blocked the deal and devalued the seller's exit.

Solution:

Insurance policy put in place to indemnify the business for losses (including settlement, damages and defence costs) in relation to any claim brought by the third party. Management given comfort to proceed with the buyout, seller able to execute clean exit and achieve greater company valuation.

Missing beneficiaries and unknown third party claims

Situation:

Administrative board appointed to manage the liquidation of an insolvent bank.

Problem:

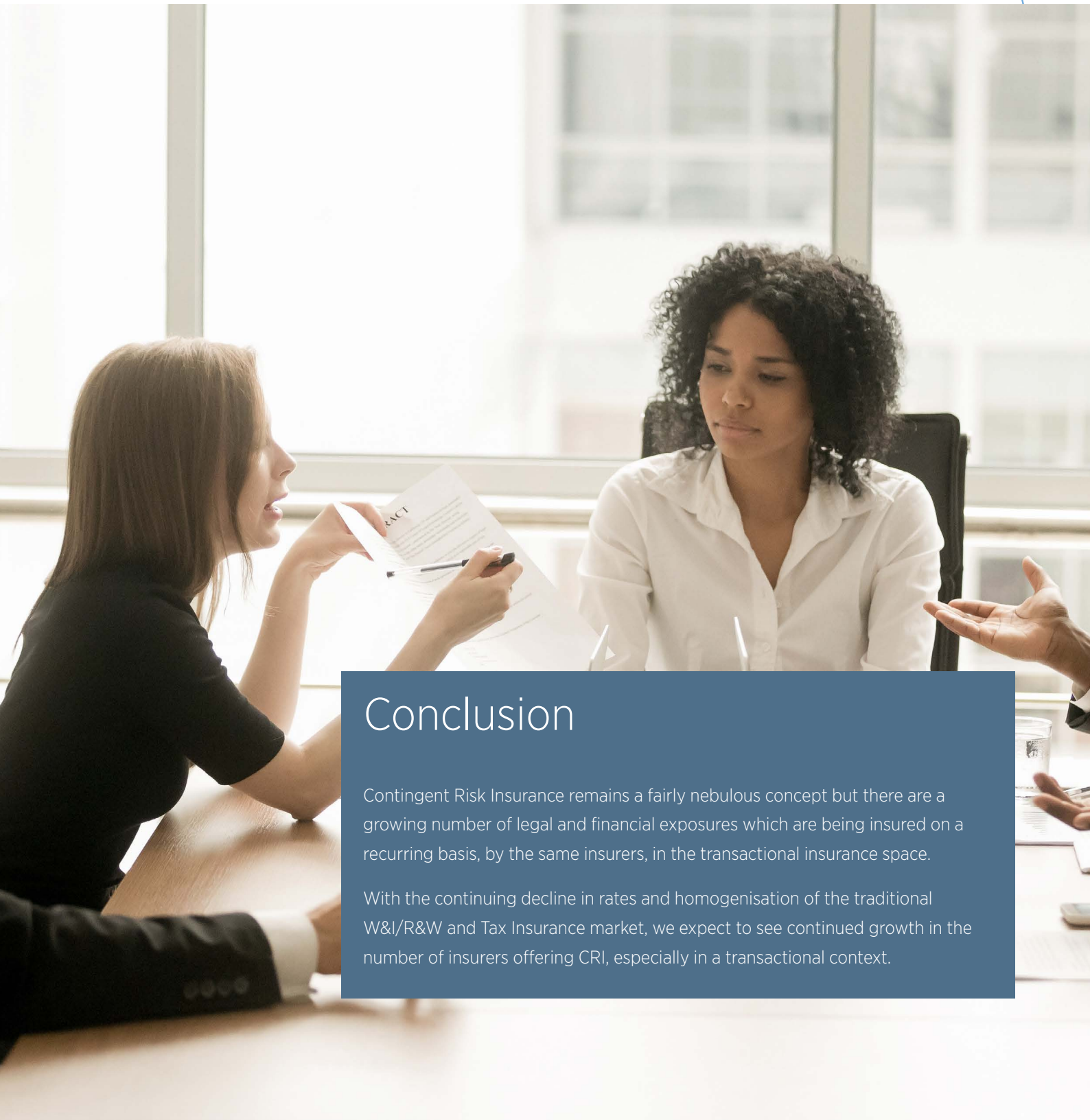
After final distributions and winding up of accounts, the bank, the administrative board and its advisors remained liable to future, unknown third party claimants and missing account holders (beneficiaries).

Solution:

Contingent risk policy placed to cover the bank, the administrators and their advisors for any third party claims and associated legal costs relating to the winding up process. Contingent Risk Insurance gave the administrators peace of mind and enabled the owners of the bank (distressed debt funds) to fully realise the bank's remaining assets.

A growing but disjointed market

The CRI market still remains very disjointed given that the range of underlying legal risks is extremely broad. Whilst there has been exponential growth in the number of underwriters offering CRI, there are significant differences in appetite and understanding. Some underwriters require a pending transaction, whilst others can look at standalone issues. There are underwriters who can insure pure discovery risks or secondary liabilities whilst others can't. Some underwriters prefer current litigation, others, pre-litigation.



Conclusion

Contingent Risk Insurance remains a fairly nebulous concept but there are a growing number of legal and financial exposures which are being insured on a recurring basis, by the same insurers, in the transactional insurance space.

With the continuing decline in rates and homogenisation of the traditional W&I/R&W and Tax Insurance market, we expect to see continued growth in the number of insurers offering CRI, especially in a transactional context.

CONTACT US

If you would like to learn more about Contingent Risk Insurance, please do not hesitate to contact a member of the team for a confidential discussion:

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