Using M&A insurance on tech deals

Issue 4: Artificial intelligence, robotics, semi-conductor/ manufacturing

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McGILL AND PARTNERS

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In our third issue, we looked at some focus areas for insurers in the fintech, edtech and healthtech/ medtech sectors. In our fourth and final note, we dig deeper into the areas of underwriting focus for artificial intelligence, robotics and semi-conductor/ manufacturing deals.

Artificial Intelligence

Key areas of focus include:

- Data protection and data ownership
- Intellectual property
- Litigation
- Research and development
- Sufficiency of IT systems

Robotics

Key areas of focus include:

- Data protection/ GDPR/ CCPA
- Intellectual property
- Military contracting rules
- Product liability
- Risk of equipment/ systems failure

Semi-conductor/ manufacturing

Key areas of focus include:

- Condition of inventory/ stock
- Environmental
- Jurisdictions
- Recycling liabilities
- White labelling

Artificial intelligence

Businesses in the artificial intelligence ("**AI**") space are truly at the vanguard of technological progress. Machine learning, image recognition, speech processing, blockchain technologies and natural language processing are just some of the areas where developments in this field are taking place. The use and improvement of AI related services is continuing to impact business, culture and society more broadly.

Contingent risk insurance is not just limited to litigation, but is a highly bespoke solution that can be used in a wide range of situations to isolate potential losses that may arise from known risks that are remote but could result in significant loss. These solutions can be used to deal with issues on or outside of an M&A transaction to mitigate risks related to an AI business.

1 Data protection and data ownership

Many AI businesses rely heavily on the collection of large amounts of data and the use of that data to continuously improve their product offerings. Insurers will expect buyers to confirm the target's rights to use the data and that those rights extend to every way in which the data is used by the target.

Buyers should ensure that a target's contracts with third parties are clear with respect to rights to and ownership of such data.

Additionally, for targets that collect or use personal information in their AI systems, insurers will expect buyers to evaluate the extent to which such targets have the necessary authority to collect and/ or use such data under privacy and data protection laws and the extent to which such targets are taking necessary steps to protect such data and prevent inadvertent disclosure.

2 Intellectual property

Understanding how the IP of the target is managed and protected will be a key area of focus for a buyer in an AI transaction.

Insurers will expect the buyer to have reviewed the target's registered patents and trademarks.

Insurers will look to get a feel for the target's general IP management processes and expect to see evidence of written standards and procedures regarding the development and protection of IP.

Importantly, insurers will want to understand whether there are any ongoing disputes with third parties concerning IP infringement.

3 Litigation

AI is a heavily litigated space. The insurer will expect the buyer to identify any notice that the target has received in writing from a third-party threatening litigation. Similarly, insurers will want to be made aware of any situations where the target is actively pursuing any litigation against a third-party.

To the extent that there is an early stage litigation where the legal advisors believe the chance of success for the buyer to be high, but the potential consequences of a loss to be material, then it is possible to explore putting in place contingent risk insurance to cover this risk.

For targets that use AI in ways that could create a potential for injury or property damage, insurers will also expect buyers to evaluate a target's product liability profile.

4 R&D

Insurers will expect the financial due diligence to evidence that R&D costs have been appropriately expensed and capitalized in the financials. Insurers may also look at the amortization policies applied to capitalized development costs and the process the target has for reviewing the recognition criteria at the end of each accounting period.

They will also expect the tax due diligence to set out the amount and usability of R&D tax credits. Depending on the accounting treatment, this may include an analysis of whether development costs are project-based, separately identifiable and whether they have been subject to a technical and feasibility study. Coverage for usability of material tax credits is usually achieved by way of a specific tax policy.

5 Sufficiency of systems

Given the importance of data to an AI business, Insurers will look to understand the systems the target has in place and confirmation that they are broadly capable of running the systems they deploy.

The buyer should identify the proportion of unplanned downtime the target has experienced, and the back-up plans in place (including contingency plans for disaster recovery/business continuity). The buyer should also be able to quantify the impact an IT failure would have as well as the target's cybersecurity controls.

Insurers will also look favorably on a business that has conducted regular testing and maintenance and evidenced investment in the systems. If no investment has taken place, then the buyer should identify the extent to which further capital expenditure is necessary.

Robotics

Rapid technological advancements have resulted in robotics being relevant to a wide spectrum of products and services, which includes autonomous vehicles, automation in manufacturing, collaborative robotics, healthtech and medtech.

Historically, M&A insurers looked to exclude issues that are typically picked up by another form of insurance, for example loss arising from product liability, professional liability or cyber. Now, where insurers are not comfortable covering these risks under the R&W/W&I policy from the ground up, they will sit in excess of the underlying insurances of the target or the buyer, subject to obtaining comfort on the appropriateness of cover in place. Where the underlying insurance is considered insufficient, it is possible to put in place specific run-off cover

1 Data protection/ GDPR/ CCPA

Where the target is in the collaborative robotics sector, data protection will be a key area of focus. Maximum coverage for data protection matters will be achieved where a full data protection audit has been undertaken. Insurers recognize that this is not always possible, particularly when the transaction is on an accelerated timeline.

Insurers will, however, expect that the buyer has reviewed data protection policies and practices of the target. The buyer will likely identify areas of non-compliance in the course of diligence. This does not automatically exclude cover for data protection, but insurers will expect the materiality of such breaches to be quantified and described, as well as a plan to improve compliance post-closing.

2 Intellectual property

Understanding how the key IP of the target is managed and protected will be a key area of focus for a buyer.

Insurers will expect the buyer to have reviewed the target's registered patents and trademarks.

Insurers will look to get a feel for the target's general IP management processes and expect to see evidence of written standards and procedures regarding the development and protection of IP.

Importantly, insurers will want to understand whether there are any ongoing disputes with third parties concerning IP infringement.

3 Military contracting rules

Where relevant, compliance with military contracting rules can be a particular concern for insurers on a robotics transaction.

Insurers will require confirmation that the target has in place all relevant and appropriate safeguards to ensure adherence with the applicable contracting rules.

Insurers will also expect a buyer to evaluate the effect of the transaction on agreements with governmental agencies and institutions, including compliance with any consent or licensing requirements.

4 Product liability

Product liability, product recall and product warranty will be key areas of focus for an insurer on a robotics transaction. The insurer will want to understand whether the target has in place insurance policies in respect of these important areas.

As part of the insurance due diligence, the insurer will expect the buyer to have reviewed whether limits in and scope of coverage is sufficient. They will also want to see whether any historic claims have been made.

it is possible for the R&W/ W&I policy to sit in excess of any underlying policies where the insurer gets comfortable with the level and scope of cover in place.

5 Risks of equipment or system failure

Where a target either sells or uses robotic systems in its own business, equipment or system failures can have severe consequences if, for example, the target's or a customer's business is largely reliant on the continuous operation of those robotic systems. Insurers will expect the buyer to carefully analyze a target's insurance coverage for such events, its contracting practices with respect to limitations on liability and its claims history.

AI-enabled robots that work side-by-side with humans also present workplace safety concerns that a buyer will want to ensure it has evaluated.

Semi-conductor/ manufacturing

2020 was the second busiest year on record for semi-conductor M&A activity and this activity has continued into 2021. While this is partly due to the closing of a few landmark transactions, an insatiable appetite for parts and a more stable political outlook in the US has led to increased confidence in the sector.

To the extent there are identified environmental issues connected with a manufacturing site, a standalone environmental insurance policy can be structured to provide protection not afforded by the R&W/W&I policy. This can be of particular use where the site is brownfield or contamination has occurred.

1 Condition of inventory/ stock

Historically, under a R&W/ W&I policy insurers would exclude all liabilities associated with the condition of the company's assets and stock on the basis that these risks are difficult to underwrite and better covered by specific insurances.

However, some insurers may be willing to consider providing cover if there is thorough technical due diligence (which would need to include site visits) reviewing the manufacturing processes, quality of stock (e.g. age, condition etc.), maintenance processes and records and machinery inspection.

A related issue is a target’s reliance on components supplied by third parties to manufacture its products. Insurers will expect a buyer to have analyzed this risk in connection with the due diligence process.

2 Environmental

Insurers will be focused on understanding the extent to which the target has any environmental liabilities.

It is typical to obtain cover for warranties referring to the target’s adherence to environmental regulations and for having necessary licenses in place. Subject to the buyer having undertaken specific environmental due diligence, the cover can often be widened. Loss arising from pollution, however, is typically excluded from R&W/ W&I policy.

There are standalone insurance policies that can be taken out by the buyer to cover off critical environmental exposures.

3 Jurisdictions

It is often the case on semi-conductor deals that the target conducts manufacturing activities in several locations across the globe. Insurers will expect the buyer to have conducted due diligence on facilities in each jurisdiction where manufacturing occurs, and they will often expect the buyer to have obtained advice from local advisors that are experts in each region unless the materiality of the site from a revenue perspective falls below a defined threshold.

Certain jurisdictions may result in the insurer looking to include limited coverage for matters related to anti-money laundering, bribery and corruption. However, such exclusions can be avoided where it can be evidenced that the target has robust anti-corruption and anti-money laundering practices in place.

4 Recycling liabilities

Businesses in the manufacturing space are facing increased pressure to both adhere to regulatory standards and demonstrate their “green credentials” to stakeholders and the general public alike. With this scrutiny in mind, insurers will pay particular attention to the target’s adherence to recycling liabilities.

The insurer will expect the buyer to understand the regulatory framework with regards to recycling and evidence that this is being adhered to. The buyer should identify any historic breaches of recycling obligations and the extent to which these have been remedied.

5 White labelling/ intellectual property

Insurers will expect the buyer to have undertaken a thorough review of licensing agreements in place with customers. They will expect the buyer to understand the liabilities owed by the target to customers. It will also be important for the buyer to demonstrate an understanding of whether there are any ongoing or historic disputes with customers around the use of products provided, particularly with regards to IP.

The semiconductor industry is characterized by fierce competition to establish and enforce intellectual property rights. IP disputes in the semiconductor industry not only impact the manufacturer, but also the manufacturer’s customers. Accordingly, it will be important for a buyer to understand a target’s litigation profile and the indemnification obligations it may owe to its customers in such cases.

The bolder your ambition, the better we become.

If you would like to discuss how to get the most from M&A insurance on an upcoming technology deal, or to find out if we can use our expertise and creativity to help you to resolve any other transaction issues, please contact:

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[1] Size according to Private Equity Investor, based on capital raised over the last five years.