Using M&A insurance on tech deals

Issue 2: Software/SaaS, internet telephony and on-demand

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McGILL AND PARTNERS

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In our first issue, we looked at how valuation, IP and cyber were areas of key focus for M&A insurers on most tech transactions. In this note, the attention shifts to distinct areas of focus for underwriters around three technology sub-sectors where deal making has accelerated in the past six months: software/SaaS, internet telephony, and on-demand.

In subsequent issues, we will look at fintech, healthtech, artificial intelligence, edtech, robotics and semi-conductor/manufacturing.

Software/Software as a service (SaaS)

Key areas of focus include:

- Material contracts
- Professional liability/ errors and omissions
- Proprietary software and open source
- Research and development
- Sufficiency of IT systems

Internet telephony

Key areas of focus include:

- Data protection/ GDPR/ CCPA
- Intellectual property
- Service liability
- Sufficiency of IT systems
- Third-party tools, hardware and software

On-demand

Key areas of focus include:

- Customer safety
- Data protection/ GDPR/ CCPA
- Employment matters
- Litigation
- Regulatory and licensing

Software/Software as a Service (SaaS)

Since the COVID outbreak, the resilience of M&A in the software and SaaS sector has been striking. Increased digitization of working, family and social life has put increased pressure on businesses to innovate and optimize their offering. The services offered by software companies can be mission critical to a business's success, making them extremely attractive and valuable targets for investment.

> A software/SaaS buyer pursuing a buy and build strategy can establish a relationship with an insurer on their initial platform acquisition to achieve favorable terms for subsequent add-on transactions.

There are a number of underwriting factors to consider when structuring M&A insurance on a Software/SaaS transaction

1 Material contracts

A key area of focus for a buyer on a software/SaaS transaction is around the contracts the target has with key customers.

Insurers will expect the buyer to have reviewed the material contracts (typically top 10) with a sampling exercise of other less valuable contracts.

Insurers will be particularly focused on any change of control provisions and whether customer calls have been carried out to assess the risk of such clauses being exercised. They will also look to understand whether the contract has been renewed in the past and how difficult it would be for the customer to change provider. They will expect any notification from customers around non-renewal/cancellation to have been disclosed.

2 Professional liability/errors and omissions

Insurers will want to establish whether the target provides 'on premise' advisory services as part of their implementation. If this is the case, then they will look to understand in which jurisdictions the advisors are based and the training that they have received and continue to receive on an ongoing basis. They will also expect any periods of system downtime to have been identified.

It is important to review any underlying professional liability/errors and omissions polices the target has in place. To the extent the insurer cannot provide cover on an outright basis, the R&W/W&I should be able to sit in excess of the existing policies are deemed to be sufficient.

3 Proprietary software and open source

A key focus for the buyer on a software transaction will be identifying the relevant IP in the business. Insurers will expect to see a review of how the IP has been developed and subsequently protected.

A buyer must review both the assignment and confidentiality provisions that are in place with current and former employees and contractors.

Insurers will also expect a specialist third-party open source review to have been undertaken and reported on. To the extent this is not available, they will expect the relevant subject matter experts of the buyer to have discussed the use of open source with the target and assessed the risk.

4 Research and development

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 IT systems

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 understanding 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 insufficient investment has taken place, then the buyer should identify the extent to which further capital expenditure is necessary.

Internet telephony

What once seemed unimaginable has now become a reality as home working has become the norm for the vast majority of office workers during the COVID-19 pandemic. This seismic shift has largely been aided by the recent strides made in the internet telephony space. Competition among providers is becoming increasingly fierce, with consolidation in the market likely to take place over the coming years.

An internet telephony buyer can obtain enhanced coverage for IP related representations/warranties under the R&W/W&I policy by extending the limit to 100% of the enterprise value and extending the period of cover to up to 6/7 years.

There are a number of underwriting factors to consider when structuring M&A insurance on an internet telephony transaction

1 Data protection/ GDPR/ CCPA

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 Service liability

The buyer should understand whether there have been any previous system outages and, if so, the period of downtime and a quantification of loss suffered.

The buyer should review contracts with customers to understand the contractual liability that the target owes. Insurers will want to understand if such liability is picked up by any existing insurance cover such as professional liability/errors and omissions.

Insurers will want to understand whether there have been any complaints about service and the impact this might have on material customers of the business.

4 Sufficiency of IT systems

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.

5 Third-party tools, hardware and software

The buyer should identify the extent to which the target's business is reliant on third-party tools, hardware and software – e.g., for on-premise appliances/devices, hosting services or network connectivity. Insurers will want to understand the extent to which the target is particularly reliant on any key suppliers and whether these key suppliers will remain in place post-closing.

Insurers will also want to understand, as applicable, the security profile of any third-party tools, hardware and software used by the target in its business.

Insurers will also inquire as to whether the target's third-party suppliers have conducted any audits to ensure the target's compliance with the terms of inbound agreements.

On-demand

The ubiquity of the personal mobile device has led to a revolution in service industry. Taxis, food delivery and dry cleaning pick-up are just some of the services that an individual can access almost instantaneously at the touch of a screen. M&A activity continues apace, with the sector having seen some high-profile mergers in recent years, as well as established players regularly acquiring smaller complementary add-on businesses. The on-demand economy has risen to become a hotly-debated subject, attracting significant governmental and legal scrutiny, presenting risks for dealmakers.

A buyer in an on-demand transaction should ensure that the target has in place sufficient insurance protection for cyber related risks or that the buyer's existing program will extend to cover the target.

There are a number of underwriting factors to consider when structuring M&A insurance on an on-demand transaction

1 Customer safety

The buyer should identify whether the target has robust policies and procedures in place to ensure customer safety. The insurer will want to understand how these have been enforced and maintained.

Insurers will expect the buyer to have identified any complaints around customer safety that have been made and understand how these have been addressed and rectified where necessary.

Similarly, they will look to understand to the extent there has been any negative coverage in the press around the safety standards of the target business.

2 Data protection/ GDPR/ CCPA

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.

3 Employment matters

The risk that contractors are re-classified as employees (or, in some jurisdictions, workers) of the target is a key area of concern for insurers in an on-demand deal. Agreements with self-employed workers will need to have been reviewed by the buyer's counsel to understand the risks that their status as self-employed might be challenged. The analysis should include an identification of the rights and benefits that might accrue, including discrimination claims, termination claims, health and safety liability, social security and tax issues.

The buyer's review should examine the law applicable in each jurisdiction in which self-employed workers are engaged.

4 Litigation

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 litigation buy-out insurance to cover this risk.

5 Regulatory and licensing

In a similar vein to employment matters, the regulatory and licensing landscape for on-demand business can be subject to regular changes as legislators try to keep up with the pace of growth of the on-demand economy.

Insurers will want to understand that the target has in place all necessary licenses to operate in each jurisdiction.

The buyer should identify any areas of historic non-compliance of regulations or licenses.

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.