

Representations and Warranties Insurance: What Every Buyer and Seller Needs to Know

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Published in the

LexisNexis Corporate Law Advisory

January 2016

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Perhaps because it was misunderstood or perhaps because it had not yet hit its stride in terms of breadth of coverage, reps and warranties insurance was hardly ever used to close deals. Like Harry Potter, it was the poor stepchild often left in the closet.

Just a few short years ago, had one tried to initiate a conversation with a private equity sponsor or an M&A lawyer regarding M&A “reps and warranties” insurance (i.e., insurance designed to expressly provide insurance coverage for the breach of a representation or warranty contained in a Purchase Agreement or a Merger Agreement [an “Acquisition Agreement”], in addition to or as a replacement for a contractual indemnity), one might have gotten a shrug of the shoulders or a polite response to the effect of “let’s try to negotiate around the problem instead.” Perhaps because it was misunderstood or perhaps because it had not yet hit its stride in terms of breadth of coverage, reps and warranties insurance was hardly ever used to close deals. Like Harry Potter, it was the poor stepchild often left in the closet.

Today that is no longer the case. One global insurance broker with whom we work notes that in 2014, it placed nearly \$6 billion in reps and warranties insurance in North America alone, nearly doubling its US-based reps and warranties writings from 2013. Reps and warranties insurance has become an important tool to close deals that might not otherwise get done, including for strategic buyers – over \$1 billion of the aforementioned broker’s reps and warranties insurance placements in 2014 were for such buyers. This article is meant to highlight how reps and warranties insurance may be of use to you in winning bids and finding means of closing deals in today’s challenging environment.

When Is Reps and Warranties Insurance Best Used?

Deal Size. Reps and warranties insurance is best suited to deals of a certain size range and type. Given the amount of limits that can be purchased in the marketplace for any particular deal, insurance pricing and the size of a typical escrow or indemnity requirement, the “sweet spot” for reps and warranties insurance are deals between \$20 million and \$2 billion; a recent Practical Law survey found that 61% of private transactions utilizing reps and warranties insurance had deal values in the range of \$100-\$500 million. While reps and warranties insurance may have a role to play in larger or smaller deals, it can play a central role in facilitating transactions within this size range.

Sell-Side Examples. For those finding themselves selling a business or asset, situations that may warrant purchase of a reps and warranties policy for the transaction include the following examples:

Minimization of Seller Liability. A private equity or venture capital seller near the end of a fund's life wishes to limit post-closing indemnification liabilities on the sale of a portfolio company in order to safely distribute deal proceeds to the limited partners, but the buyer wants a high cap on potential indemnities or a long survival period for the reps and warranties at issue. Insurance could be the means to bridge this gap.

Removal of Tax Contingency from Negotiations. A seller restructures itself immediately prior to the closing of a deal for tax purposes. During due diligence, both seller's and buyer's tax advisors agree the deal should be recognized as a tax-free reorganization. In the remote event that the IRS took a different position, the tax consequences to the buyer would be significant. The seller wishes to retire with the proceeds from the deal, and does not want to provide an indemnity to the buyer for this potential risk. Insurance could serve to remove this risk from the scope of matters needing negotiation between the parties.

Minimization of Successor Liability Risk. In an asset sale transaction where a portion of assets and liabilities remain with the seller, the buyer would have no control over the seller's conduct post-closing and does not want to be subject to potential liabilities related to such excluded assets on a successor liability theory. If the seller is unwilling or unable to provide an indemnity for such matters, insurance could help the parties past this issue.

Buy-Side Examples. For those wishing to acquire a business or asset, situations that may warrant purchase of a reps and warranties policy for the transaction include the following examples:

Bid Enhancement. A competitive auction process is being held by a seller of prime assets. A potential buyer wishes to distinguish his or her bid from others by arranging and agreeing to look to a reps and warranties insurance policy to reduce or take the place of an indemnity from the seller. Such a use of insurance could elevate the likelihood of the buyer winning the auction.

Distressed M&A Indemnity. Similarly, in a distressed M&A setting in which the buyer is concerned about the credit risk of the seller post-closing, the use of reps and warranties insurance would enable the buyer to be indemnified for breaches of reps and warranties in the acquisition agreement, while avoiding the seller's credit risk.

Enhanced Survival and Coverage. Buyers may obtain (i) a longer survival period of reps and warranties than may be typically obtained from sellers (e.g., 3 years for general reps and 6 years for fundamental and tax reps) and (ii) coverage limits not tied to a percentage of the purchase price (thus allowing buyers to obtain more coverage than can be typically obtained from sellers).

What Should the Insurance Cover?

While each policy is unique, a reps and warranties policy generally covers "Loss" from "Claims" made by the buyer for any breach of, or an alleged inaccuracy in any of, the representations and warranties made by the seller in the Acquisition Agreement. Though a rep and warranty policy can be structured to cover very specific reps or warranties, coverage is generally afforded on a blanket basis for all reps and warranties to the extent such reps and warranties are "market" and not overly buyer-friendly. The definition of "Loss" in the policy should generally mimic the extent of the indemnity negotiated in the Acquisition Agreement (which could include things like consequential or special damages). Loss can also include defense costs, fees, and expenses incurred by the insured (for instance, the seller) in defense of a Claim brought by a third party (for instance, the buyer) arising out of alleged breach of a representation or warranty.

What Should the Insurance Exclude?

Though the exclusions in a reps and warranties policy are not as numerous as those contained in a traditional directors and officers liability policy, they do exist and should be thoughtfully considered and negotiated. Reps and warranties policies do not cover known issues, such as issues discovered during due diligence, described in disclosure schedules, or so-called "new new" matters both occurring and discovered by the insured in the interim period between signing and closing. They also do not cover purchase price, net worth or similar adjustment provisions contained in the Acquisition Agreement, benefit plan underfunding issues, certain environmental liabilities, foreign corrupt

practices and bribery issues, warranty and product liability claims in certain industries, and availability of net operating losses in certain contexts. “Sell-Side” reps and warranty policies do not cover claims arising from the adjudicated fraud of the seller. Either buy side or sell side policies might have deal-specific exclusions where the carrier involved simply cannot get comfortable in insuring the particular representation or warranty at issue. Lastly, a rep and warranty policy would also generally not cover any breach of which any member of the deal team involved had actual knowledge prior to the inception of the policy or any material inaccuracy contained in the “No Claims Declaration” typically signed by the insured in connection with the policy issuance.

Cost of Coverage

Reps and warranties insurance is priced based on a number of factors, including most prominently the nature of the risk involved, the extent of the due diligence performed by the parties, and the relative size of the deductible. Reps and warranties insurance is currently generally priced as a percentage of the limits of coverage purchased. Nowadays, in the United States, a price range of 2.5% to 4.0% of the coverage limits is typical. Thus, a reps and warranties insurance policy with a \$20 million limit of liability on a moderately complicated deal might cost approximately \$650,000. Since proceeds from a reps and warranties policy may result in net taxable income to the buyer, a tax gross-up feature may be available for additional premium. Who pays this premium is generally a function of the deal, and depends to some extent upon who is deriving the benefit from the insurance. If, for instance, a buyer-side policy is being purchased because a seller doesn't want to deal with putting up an indemnity or hold-back, the premium would generally be the seller's responsibility.

In order to facilitate the due diligence process (described below), many carriers require payment of an up-front underwriting fee. These fees can run from \$25,000 to \$50,000 (with an additional payment of approximately \$5,000 for each excess layer of insurance involved in the deal), and are typically used by the carrier to hire outside counsel to advise it during the underwriting process.

Deductible

Reps and warranties policies almost always have a self-insured retention (“deductible”) associated with them. The size of the retention can vary considerably from deal to deal, but carriers typically determine the policy’s deductible according to the transaction value of the deal. In our experience, the current standard deductible ranges from 1% to 3% of the transaction value. The deductible will, however, vary from deal to deal based upon the risk involved. Buy-side policies in “low indemnity” transactions (i.e., those with some seller “skin in the game”) tend to use the “hold-back” negotiated between the parties as a deductible.

Process to Get the Insurance in Place

The reps and warranties insurance market has evolved in response to prior concerns about the amount of time and effort necessary to put a policy in place. The carriers and brokers understand that, as with the deals themselves, the need for the insurance is typically on a very fast track.

Many of the large national insurance brokerages have specialized units that deal with reps and warranties insurance. These units, for the most part, are run not by “insurance people” but by former M&A lawyers who left private practice to become dedicated resources at the brokerages. They are fully familiar with the ins and outs of M&A and private equity transactions, and very little time is needed to get them up to speed. Though not all brokerages provide the same level and depth of resources, the right broker can become quickly integrated into the deal team and, importantly, will serve as an advocate with the insurance carriers.

Within 24 hours, a good broker will have you engaged with one of the several carriers that are known to service the reps and warranties insurance area. Be advised that not all carriers are created equally, and your broker should assist in advising as to selection of the best carriers for your purposes (including as to responsiveness, experience in corporate transactions, and reputation for proper claims payment decisions).

The best insurance carriers in this arena will typically provide a price and coverage quote (called a “Non-Binding Indication” or “NBIL”) within two or three days of the first conversation. Either in connection with the receipt of the NBIL or in a subsequent phone call, you should expect to receive a list of due diligence requests, and likely a request of the carrier for data room access. Both the broker and carrier are accustomed to negotiating and executing a Non-Disclosure Agreement (which may be a joinder to such an agreement between the buyer-insured and the seller or target company) early in the process. The best carriers in this arena are, in our experience, capable of running a very efficient due diligence process and getting up to speed quickly regarding potential risks associated with the deals (e.g. intellectual property, environmental, etc.).

Within a week of receipt of the NBIL, the carrier and its counsel (the carrier will often by this point have signed one or more Non-Reliance Letters in connection with the circulation of due diligence memoranda), the insured, its business people, its deal team members and its counsel (including sometimes the private equity sponsor) will typically discuss the due diligence done on the transaction, and answer questions of the insurance carrier and its counsel to ensure the absence of any risks that might imperil the insurance transaction. Assuming the due diligence call goes well (and there may be follow-up diligence calls and e-mails as well on particular issues), the carrier involved will normally issue a draft insurance policy, which is normally then negotiated between the parties (assisted by the broker and insured’s counsel). A key issue will be “conforming” the insurance so that it matches what would otherwise have been provided by the Acquisition Agreement in the absence of the insurance (or otherwise serves the particular need for which it is being purchased). In negotiating such a policy, focus will often be placed on defining the scope of losses included and excluded from coverage, the policy period, operational restrictions, subrogation provisions, and a host of additional issues beyond the scope of this article. In a competitive bidding context, note that carriers will typically not begin underwriting until a bidder has formal or de facto exclusivity.

Claims

While it is difficult to obtain specific claims data, a global insurance underwriter with whom we work notes that claims notices have been received on 28% of the policies it has issued in North America since it began underwriting reps and warranties insurance, and that it paid over \$100 million in claims worldwide in 2014; a global insurance broker with whom we work states that claim frequency in European and Asian policies is approximately 12%. Another global insurance broker with whom we work notes that approximately half of the claims it has handled for clients were ultimately settled or resolved within the policy retention, and that the average claim payment to date that exceeded the retention was \$1.79 million.

In Summary

Reps and warranties insurance (1) can often be purchased quickly and efficiently, and if handled timely need not delay the deal, (2) can provide real coverage for troublesome aspects of a deal for which alternative solutions may not be readily available, and (3) can serve as a flexible tool to distinguish one's offer in a competitive bidding situation. Teaming up with a well-experienced broker and insurance carrier is essential to making this happen. We have enjoyed the benefits of utilizing reps and warranties insurance in numerous transactions, and would be happy to share with you our thoughts in this arena in further detail.

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