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Reps And Warranties — Keeping M&A Liabilities In Check

Law360, New York (May 01, 2015, 10:14 AM ET) -- In recent years, representation and warranty insurance has gained popularity as a tool to decrease transaction liability exposure in mergers and acquisitions. These policies can be particularly useful in the context of cross-border transactions, for both financial and strategic parties, to facilitate middle-market transactions involving foreign buyers or sellers of domestic U.S.-based businesses. The product is also beginning to gain traction in transactions outside the United States.

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As the M&A market heated up in 2014, particularly in middle-market transactions, so did the market for representation and warranty insurance (RWI), a transaction liability insurance[1] product that has become an increasingly utilized tool to assist M&A professionals close their deals.

RWI has been available since the ’90s, but in the early days its use was limited to transactions involving sellers reluctant to provide fulsome indemnity packages[2] and middle-market public deals in which acquirers did not expect post-closing rights of indemnification. Over the years, the cost of obtaining RWI has decreased dramatically. The cost to obtain such coverage today is significantly lower than the premiums charged even five years ago. Additionally, until recently the product was relatively unknown, issued by only a few carriers and was coupled with market uncertainty as to whether the insurance carrier would honor and pay claims made under the policies.

However, in the last few years the market for RWI has expanded greatly, particularly in the United States. Insurance brokers estimate that RWI policies with aggregate policy limits of approximately $10 billion[3] were issued in 2012, $15 billion in 2013 and the estimates for 2014, while not yet in, are expected to show another substantial increase as the use of the product has grown significantly with the general increase in M&A activity. Indeed, there have been reports in the trade press indicating a four-fold increase in coverages written in the last two years.

During 2014, RWI was considered in about 10 percent of middle-market deals, and one nationally recognized broker secured approximately 140 policies with aggregate underwriting limits of $6 billion from approximately 350 submissions to market.

There are numerous factors that have driven the dramatic increase in the use of RWI policies:

- The continuing increase in middle-market deals (deals ranging from $25 million to $2 billion enterprise value) as compared to mega public deals.
- The desire of private equity sellers to limit their indemnity exposure and limit holdback or escrow obligations.
- The desire of established private equity funds, including many pre-financial crisis funds, and funds completing their final portfolio investments, to close out their funds and fully distribute sale proceeds to their limited partners.
- The ability of a buyer, financial or strategic, in a competitive auction process to enhance its bid relative to its competitors.
- The increasingly lofty deal valuations, which render unacceptable to deal participants the incurrence of unknown liabilities post-closing.
- The ability of a buyer to mitigate risks associated with a seller who is or may be perceived to be a high-risk indemnitor, such as situations involving a distressed seller or a foreign seller that may be considered a collection risk, such as a seller based in a jurisdiction that may not offer robust means of recourse if a breach occurs.

RWI is an insurance product in which either the buyer or seller in an M&A transaction secures protection against breaches of the representations and warranties made by the target company or sellers in the purchase and sale or merger agreement that are discovered post-closing. RWI may reduce or even eliminate the need for escrows or purchase price holdbacks[4] and indemnity retention limits, thereby facilitating completion of M&A transactions. While the typical policy will not insure a buyer against breaches of representations or warranties known to the insured, the knowledge standard is typically the "actual" knowledge or awareness of the insured's deal team performing the due diligence review, its management team and board of directors.

By reducing or eliminating an escrow or purchase price holdback at closing, a seller can avoid a situation in which a sizeable portion of purchase price proceeds are held back, potentially earning little to no interest for a significant period of time. This can be particularly attractive to a private equity seller that (a) seeks to maximize returns on its invested capital, rather than tie up escrow funds in a low interest-bearing instrument, and (b) seeks to distribute fully proceeds of a sale to its limited partners, especially private equity funds that are at or near the end of their fund lives.

RWI is also attractive in situations involving multiple sellers who may have different levels of indemnity obligations to a prospective buyer (i.e., several versus joint and several liability) or in the case of an equity rollover transaction or partial management buyout situation in which a majority buyer may not want to seek post-closing claims against a continuing management team that comprises part of the selling group. RWI is an effective tool to assist such a buyer to avoid asserting a post-closing claim against, and thus risk demotivating, a management team that holds equity in a deal whose allegiances will shift from the selling group to the buying group concurrent with the deal closing.

While RWI can be purchased by either a seller or buyer, there are important differences in the policies and it is typically advantageous to secure a buy-side policy.

Buy-side polices:

- May protect against seller fraud while sell-side policies will not.
- Enable buyer to recover losses directly from the insurer without the need to pursue remedies against seller.

Sell-side polices:

- Will not protect against seller fraud.
- Provide "third-party" coverage (i.e., the policy will cover defense costs and losses asserted by the buyer).

Both buy-side and sell-side policies will provide coverage for all representations and warranties (subject to negotiated exclusions), including those related to financial statements and undisclosed liabilities. Since the risk of breach shifts from the seller to the RWI carrier for losses in excess of the negotiated thresholds, RWI will often allow the parties effectively to bridge differences in the "bid and ask" of the representations and warranties within commercial norms.

One open area is whether RWI policies will provide coverage for multiple-based damages, typically damages expressed as a multiple of a negotiated earnings before interest, taxes, depreciation, and amortization (EBITDA) or similar financial target, generally arising from a breach of financial statement representations and warranties. RWI policies provide at least the potential for a buyer to recover damages based upon a multiple of earnings, but the parties must take care in negotiating the specific terms of the RWI policy and waiver of consequential, special and indirect damage provisions, lost profits and diminution of earnings provisions of the underlying acquisition agreement to obtain the intended deal consequences.[5] The RWI product may enable the parties to bridge the gap in a negotiation in which the seller may be reluctant to offer any recovery for consequential, special or indirect damages or diminution of value or multiples of earnings damages.

RWI policies can also provide for a longer survival term than a seller may be willing to offer, typically at little to no increase in premium cost. However, the typical RWI policy will not extend coverage, including coverage for fundamental warranties, beyond a term of about six years.

Typically, RWI policies will not cover certain liabilities, such as environmental liabilities, liabilities arising from adverse tax rulings relating to intended tax treatment of a particular tax position, or outcomes in pending litigation matters, although separate insurance products are often available to cover such risks depending on the facts and circumstances, and coverages can be written to complement RWI coverage.

Typical RWI policies are well-suited for the increasing number of middle-market M&A deals with enterprise values of between $25 million and $2 billion and, according to Aon Transaction Services, policy limits of $350 million or greater are available in the market. In smaller and larger deals, the economics of securing an RWI policy may not be supportable by the inherent costs of the product nor may the product be ideal in a situation in which there is perceived to be a low risk of unknown or contingent liabilities. The cost of RWI has been declining in recent years. Typically, insurance carriers look for an indemnity deductible and/or holdback/escrow of 1-2 percent of enterprise value (which can be split between buyer and seller). Carriers look favorably on such deductibles, holdbacks and escrows as demonstrating the principals' willingness to have "skin in the game." In such circumstances, the insurance premium is typically around 3-4 percent of the limit of liability.

By way of example, assuming an enterprise value of $100 million and a buyer requirement to escrow 10 percent of the purchase price for a period of one year to 18 months, a transaction could be alternatively structured using RWI (assuming a 3.5 percent premium cost) as follows:

- The buyer agrees to a $500,000 indemnity deductible.
- The seller agrees to a $500,000 escrow of funds for a one-year term.
- The buyer secures RWI with a limit of $9 million at a cost of $315,000 (3.5 percent of policy limit).
- The insurer agrees to a three- to six-year term of the policy, thereby extending the general representation and warranty survival period typically requested by the buyer.
- At closing and assuming the seller bears the cost of the RWI premium (3.5 percent or $315,000), the seller will net $99.185 million[6] versus $90 million with a one-year to 18-month escrow of $10 million and no RWI.

Private equity funds desiring to sell portfolio companies with limited residual escrow and indemnification obligations have used RWI as a method to facilitate their auction processes effectively creating a "stapled insurance" package in certain auction sales. In this situation, at the commencement of an auction process, a PE fund can determine the level of post-closing indemnification/escrow obligation, if any, that it is willing to assume and structure an RWI package to achieve the desired effect.

For example, a PE fund may, as part of the offering terms, require bidders to rely on coverages provided by an RWI policy in place of a typical escrow of a portion of the purchase price and provide that the PE fund seller and a prospective buyer would share a 1-2 percent indemnity deductible/escrow holdback. In this context, the PE fund will typically "pre-clear" the deal with potential insurance underwriters by providing recent financial statements of the target, the management presentation or confidential information memorandum and draft divestiture agreement to determine availability of RWI for the particular target company. In this context, bidders will be directed to work with the insurance broker with a view to acquiring a buy-side RWI policy. In a situation where the PE fund is near the end of the term of its fund, it may require that RWI be placed on the basis of no indemnity or post-closing escrow although the cost of RWI in such context would be significantly higher.

One area in which it has been challenging to obtain commitments to write RWI is in health care-related transactions, which involve governmental reimbursement for medical or other claims. Given the growing number of transactions in this space, it will be interesting to observe whether carriers become more amenable to issuance of policies as the number of transactions increases and claims expertise develops in this area.

The process for securing a binder for RWI insurance has become streamlined and, whether initiated by the buyer or the seller, typically involves engagement between the insurance broker and the potential buyer (assuming the goal is for the issuance of a buy-side policy), delivery of a nondisclosure agreement by the insurance broker and potential carriers to the buyer (or joinder to existing NDAs between the principals), providing to the insurance broker financial statements of the target, the confidential information memorandum prepared by the seller, drafts of the acquisition agreement and disclosure schedules, and the legal, financial and other due diligence reports or summaries thereof prepared on behalf of the buyer and the conduct of a due diligence call between the broker and the buyer.

Typically the entire process can be completed in a two-week period. In most instances, the broker will require payment of an upfront underwriting fee[7] to cover the costs for its review of the transaction and retention of legal counsel for the carrier to review the transaction documents, diligence reports and preparation of the draft insurance policy. If the insurance is bound, the premium is customarily paid in a lump sum at closing with no further premiums due after closing.

It should be noted that a concern sometimes raised as a criticism of the RWI product is whether the carriers would actually respond to losses and pay legitimate claims. At the

inception of these policies, there was limited claim history and concern about the willingness of carriers to respond to claims. While claim history information is anecdotal, it is generally understood that claims are asserted in about 20 percent of issued policies and that most claims fall within the self-retention loss of the issued policies (1-2 percent of enterprise value). Insurers recognize the necessity to pay, and to maintain their reputation for responding to, legitimate claims since brokers marketing such products would be hesitant to write policies with carriers known to deny legitimate claims, particularly given the small number of active carriers in the market. Also, sophisticated parties understand that the process to assert a direct indemnity claim against escrowed funds may involve an adversarial process, which may be even less attractive than asserting an insurance claim.

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[1] Among the types of transaction liability insurance products available are representation and warranty insurance, tax insurance, litigation buyout insurance, environmental liability insurance, fraudulent conveyance and successor liability coverage policies.

[2] In an early transaction negotiated by the author, the patriarch of a legacy family business sought to protect family members, who through estate planning had become the principal owners, against post-closing claims for breaches of representations and warranties while the PE buyer required its standard indemnity package and an escrow of a portion of the purchase price. By including RWI in the negotiated deal, the positions of the parties were bridged and the deal successfully closed with no post-closing claims ultimately asserted.

[3] Reported by Aon Transaction Services, a nationally recognized insurance broker, while an article by Law360 ("Insurers Fight to Keep Up As Deal Insurance Goes Mainstream") reported that $3 billion of policies were written in 2012.

[4] The premium for a RWI policy will typically be higher in situations where there is no indemnity deductible or escrow holdback as compared to transactions in which there is some liability retention by the buyer and/or seller.

[5] RWI policies are typically negotiated between the insurance broker/carrier and the buyer (seller in the case of sell-side policies). The policy is a negotiated form, not a "standard" policy, and will include deal-specific exclusions including exclusions for "actual knowledge" by the insured of breaches of representations and warranties, breaches relating to the existence of a particular state of affairs post-closing, and purchase price adjustments expressed in terms of an EBITDA or other financial metric multiple.

[6] $100 million less $500,000 escrow less RWI premium of $315,000.

[7] The underwriting fee is typically assessed once the prospective buyer has been granted exclusivity in the deal process and ranges from approximately $20,000-$50,000.

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