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M&A ACADEMY

**Representation and Warranty Insurance in
Strategic and PE Deals**

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Background

- Origins of rep/warranty insurance
 - Seller policies as a recourse back-stop
 - Growth of private equity investing
 - Desire to distribute transaction proceeds without overhang
- Continued growth of competitive M&A markets
 - Perceived scarcity
 - Buyer need to deploy capital (both strategic and private equity)
- Seller favorable conditions
 - Increased valuations
 - Seller favorable terms
 - Rep/warranty insurance has played a crucial aspect
- Market acceptance of structure + strong M&A markets = expansion of insurers

Introduction

Representations and Warranties

- Statements of fact and assurances made by the parties
- Sample reps include:
 - Authority/authorization
 - Ownership
 - Financial information
 - Other matters related to operation of the business (e.g., intellectual property, environmental, employee benefits, etc.)
- Diligence “guarantee” - disclosure of material facts
- Allocation of risk between the parties
- Representations and warranties impact indemnification and closing/termination
 - Insurance only addresses breaches for indemnity purposes (not closing)

Representation & Warranty Insurance Overview

Goal: Provide coverage for financial losses resulting from breaches of representations and warranties made by target company or sellers contained in purchase agreement

- Policy used to protect the insured from unanticipated (unknown) losses that may arise subsequent to the closing
- Absent diligence gaps or “red flags,” policy generally covers all representations and warranties in the purchase agreement as well as certain tax indemnities
- Either buyer or seller can be the insured under the policy

Market for R&W Insurance

- Over 2,000 R&W insurance policies bound annually.
- Competition still keeping pricing in range of 2.25% to 4.0% of limits.
- Competition also contributing to improved coverage.

*Data from (1) Aon's "North America M&A and Transaction Solutions – Risk in Review 2019" Available at <https://www.aon.com/m-and-a-riskinreview/index.html>, and (2) SRSAcquiom <https://www.srsacquiom.com/our-insights>

R&W Insurance – Basics

Coverage:	Typically covers full set of negotiated reps & warranties relating to the target company and selling shareholders, including tax matters.
Capacity:	Limits up to ~\$1 billion available in current market.
Pricing:	Generally 2.25% to 4.0% of limits (i.e., \$225,000 to \$400,000 per \$10 million in protection).
Policy Period:	Typically 3 years for general representations and warranties and 6 years for fundamentals.
Retention:	Typically 1% of the transaction value with drop down to 0.5% after expiration of general survival period. Lower retentions seen in higher value transactions (~\$1B).
Insurer Diligence Fee:	Generally between \$25,000 to \$40,000 and payable upon entering underwriting.
Standard Exclusions:	Forward looking statements and projections, covenants (can be considered in some situations), known or disclosed items (may be addressed via a separate contingency policy), asbestos and PCBs, pension underfunding, collectability of receivables.
Deal Specific Exclusions:	Exclusions may be proposed at non-binding indication stage (FLSA/Wage & Hour, Cyber/Data Security, Product Liability, Warranty, Recall, S-corp election, Environmental, etc.) or based on diligence findings (identified/known issues or insufficient scope of diligence).

R&W Insurance – Typical Motivations

Buyers

- Distinguishing bid characteristic in competitive environment
- Protect key relationships
- Increase indemnity coverage
 - Provide extended recourse beyond expiration periods
 - Provide recourse when not otherwise possible (e.g., bank/fund seller, numerous sellers, distressed company, etc.)
- Reduce/eliminate seller chase risk

Sellers

- Attract best offer in competitive environment by maximizing buyer indemnity potential while not expanding seller exposure
- Reduce seller indemnity exposure / cleaner exit
- Protect passive owners
- Distribute proceeds sooner with less overhang
- Benefit from the seller favorable trends

Key R&W Policy Issues

Retention

- Erosion structure with escrow (drop down after expiration of general survival period)

Definition of Loss

- Typically incorporates definition from acquisition agreement.
- Punitive damages (except for third-party claims) and fines and penalties typically excluded unless insurable under applicable law
- Consequential and multiplied damages - policy will mirror silence in acquisition agreement

Materiality Scrape

- Insurers typically will follow materiality scrape in the acquisition agreement and can add synthetic in no-seller-indemnity deal

Tax Coverage

- Pre-closing tax indemnity / tax rep alone / synthetic policy coverage
- Consider whether tax attributes are covered under policy or if additional coverage is available

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Key R&W Policy Issues (Cont.)

Interim Period Coverage on Split Sign and Close Deals

- Coverage bound at signing – 10% of premium typically due at signing (non-refundable if transaction does not close), can cover unknown breaches as of signing.
- Interim breach coverage – no coverage for breaches discovered between signing and closing that are not breaches as of signing.
- Acquisition Agreement mechanics between signing and closing important.

Diligence Documentation/Scope

- Scope of diligence on international targets important.
- Identified issues/risks in diligence – how do insurers treat.

Subrogation

- Waiver; fraud
- Customers

Costs: Can be shared with seller; Surplus Line Taxes; Underwriter fee; Broker fee

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Purchase Agreement Considerations

- Escrow approach – given pressure on indemnity escrow size (and common approach on retention split), consider need for separate escrow for purchase price or other matters
- Various indemnity provisions
 - Sole and exclusive remedy
 - Priority of recourse
 - Seller issue vs. policy issue
 - definition (or silence) for damages
 - control of third party claims
- Disclosure schedule updates / closing conditions – what information does buyer really want to know between closing
- Specific covenants on obtaining insurance
- Sandbagging – regardless of buyer/seller approach on sandbagging, policy will not cover breaches known to buyer team
- Fraud – seller favorable fraud limitations (limited to reps only) + buyer side RWI policies = policy coverage

Sample Seller Liability Models - \$500M EV Transaction

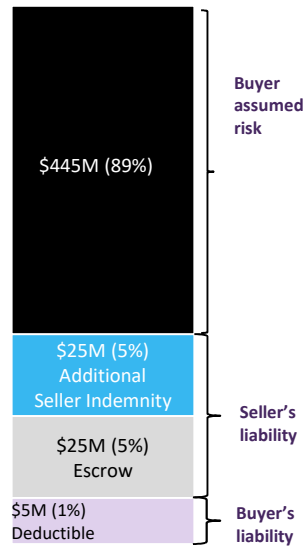
SELLER FAVORABILITY



NO SELLER INDEMNITY

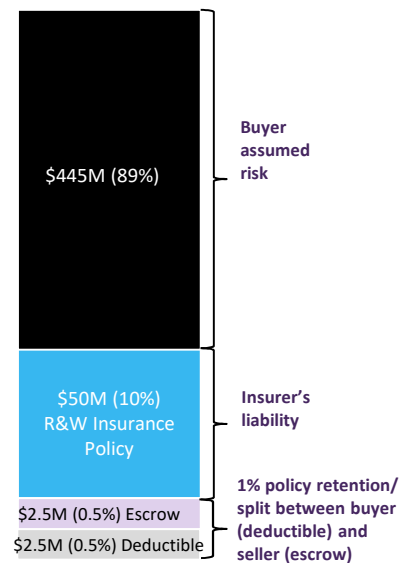
Seller Indemnity; No RWI

Transaction with 1% deductible, 5% escrow, 5% additional seller indemnity (i.e., overall 10% cap), no rep/warranty insurance policy



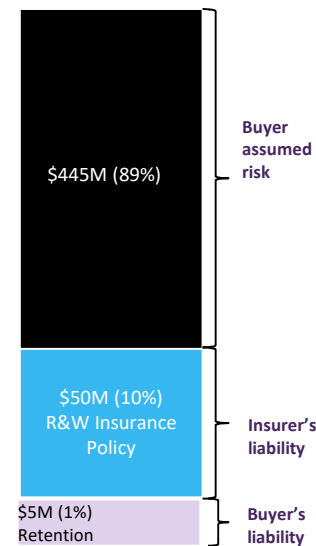
Seller Indemnity w/ RWI

Transaction with 1% policy retention, 0.5% deductible, 0.5% escrow, 10% rep/warranty insurance policy



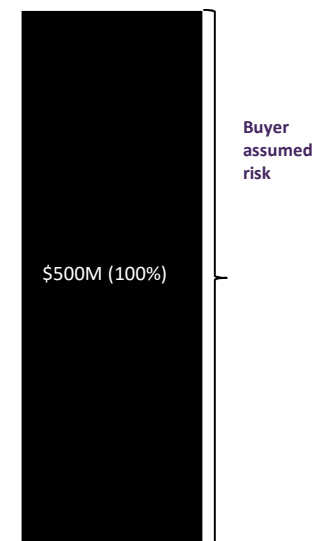
No Seller Indemnity w/ RWI

Transaction with 1% policy retention, 10% rep/warranty insurance policy



No Seller Indemnity; No RWI

No seller indemnity and no rep/warranty insurance policy



Customary Underwriting Process Timeline

Days 1 – 2

Engage broker (earlier in the process is better)
Broker and potential underwriters execute NDAs

Note: involvement of buyer's broker specializing in RWI is essential to help manage and drive process and timeline

Days 3 – 6

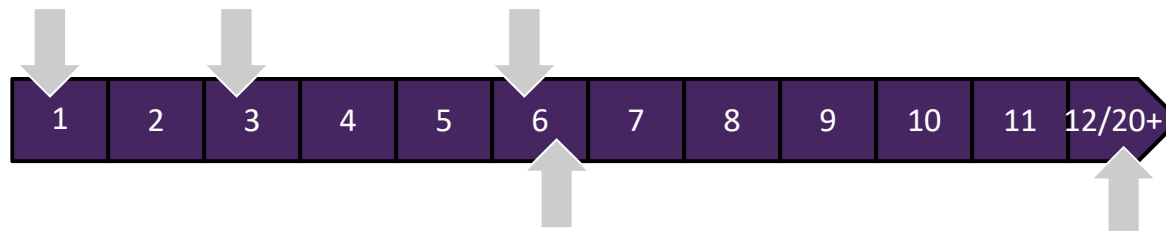
Broker obtain quotes (non-binding indications) from underwriters

- In order to get quotes, provide initial information, including draft acquisition agreement, information memorandum and target's financials
- No cost to obtain quotes

Day 6

Select underwriter

- Broker to discuss pros and cons of proposals
- Insurer diligence fee become payable upon entering underwriting (\$25K – \$40K)



Days 6 to 12/20+

Underwriting of policy

- Underwriter to gain access to data room and legal, financial, tax and other diligence reports (subject to non-reliance letters)
- Conference call with deal team and advisors

Policy negotiations

- Done in parallel with underwriting; outside counsel typically involved

Process/Timing/Exclusivity

- Seller indications based on the auction form of purchase agreement
- Communicate to optimize underwriting, including:
 - Scope of buyer's due diligence and involvement of third party advisors
 - Anticipated timing and scope of diligence reports
 - Timing of acquisition agreement mark-up
- Underwriting process and exclusivity
 - relatively uncommon to complete underwriting when multiple bidders participating in bid stage of an auction
 - "pre-exclusivity" fee

Strategic Buyer Considerations / R&W Policy Next Evolution

Strategic Considerations

- Market is rapidly changing, some strategic buyers remain hesitant to embrace R&W insurance
- Buy-side diligence approach - Team members; Diligence reports; Buyer 'comfort' on diligence on specific matters
- Insurance vs. M&A; opportunity to leverage existing insurance relationships

Next Evolution

- Continued expansion of product offering and coverage protection
- Acceptance of 'no seller indemnity' structure
- Decrease in pricing pushes down the floor of insurable deals
- "Public style" deals
- Public deals
- Minority Investments
- Possible M&A downturn

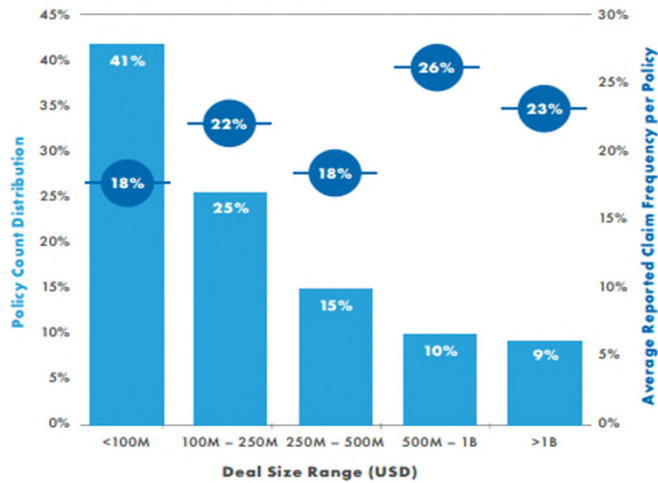
R&W Claims

AIG Claims Intelligence Series – Representations and Warranties Insurance Global Claims Study 2019 available at

<https://www.aig.com/business/insurance/mergers-and-acquisitions/mergers-acquisitions-claims-reports>

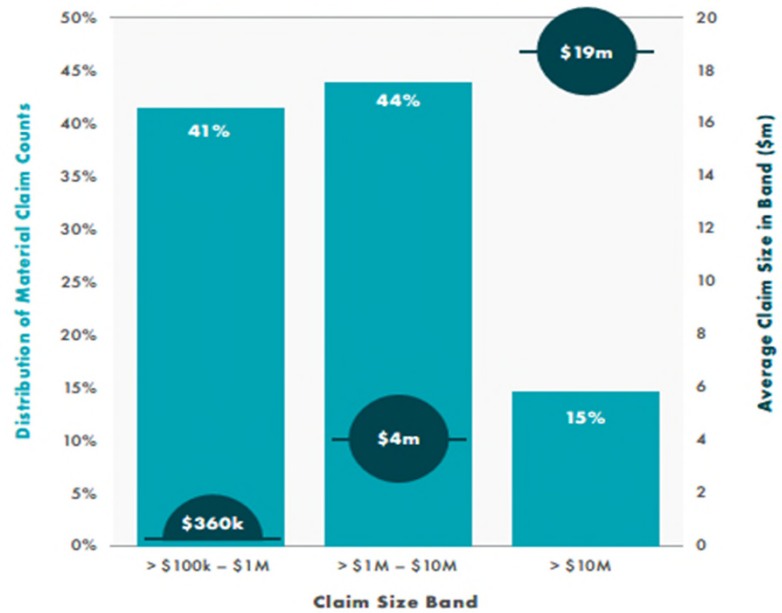
Claim Frequency and Severity

Fig 2 R&W Reported Claim Frequency by Deal Size



- Average Distribution of Policy Count
- Average Reported Claim Frequency

Fig 1 R&W Material Claims – Distribution of Material Counts and Average Size by Claim Size Band



- Distribution of Material Claim Counts
- Average Historical Severity

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R&W Claims

AIG Claims Intelligence Series – Representations and Warranties Insurance Global Claims Study 2019 available at

<https://www.aig.com/business/insurance/mergers-and-acquisitions/mergers-acquisitions-claims-reports>

Fig 3 Distribution of Average Claim Report Lags from Policy Inception Date (in Months) – Policy years 2011-15
(numbers may not add up due to rounding)

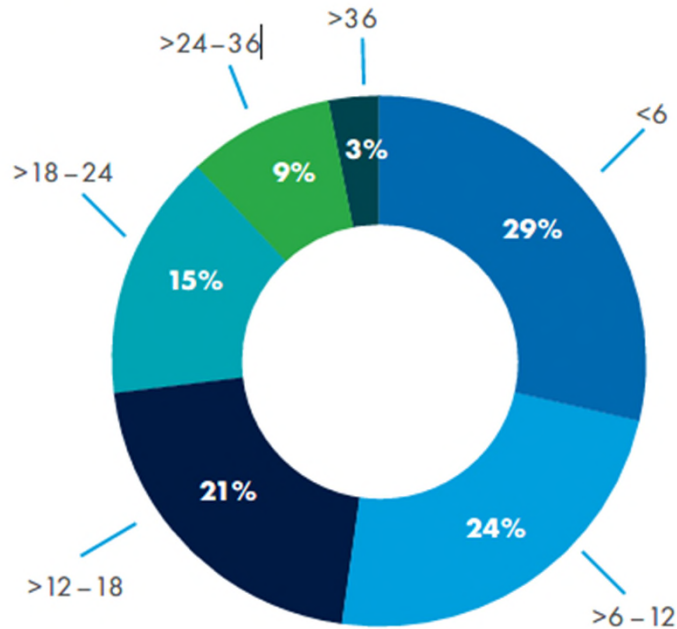


Fig 4 R&W Reported Incidents by Breach Type



Recent Litigation

In September – lawsuit filed in New York state court

Defendant Insurers: Illinois Union Ins. Company (Chubb)

Lloyds Syndicate 4000 (Ironshore Pembroke)

Barbican Trans. Liability Consortium 9804

Arch Reinsurance (Bermuda) Ltd.

\$150 million tower

\$30m Primary: N. Am. Capacity Ins. Co./Interstate Fire/Aspen

\$50m Excess: Vale/Ironshore (AON Sidecar) /Barbican (AON Sidecar) /Arch (AON Sidecar)

\$50m Excess: Illinois Union (Chubb)/Ironshore (AON Sidecar) /Barbican (AON Sidecar) /Arch (AON Sidecar)

\$20m Excess: N. Am. Capacity Ins. Co./Interstate Fire/Aspen (Euclid)

Key Takeaways from This Session

- Continued market acceptance, driven by current seller favorable environment
- Increase in providers and continued expansion of policy offerings
- Decrease in pricing = more deals insurable
- Be mindful of differences in deals with RWI
 - Timing; deliverables
 - Negotiation of deal terms
 - Negotiation of policy terms
- Consequences of a downturn in M&A markets

QUESTIONS?



Biography



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Colby W. Smith counsels clients in business law matters, with an emphasis on public and private merger and acquisition transactions. He represents strategic clients and private equity funds in acquisition and divestiture transactions and portfolio company matters. He also represents seed, institutional and strategic investors in private capital raising transactions.

Colby represents clients in a variety of industries, including technology, healthcare, manufacturing, sports and entertainment, aerospace and defense, retail and consumer products

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Ariane Baczynski focuses her practice on complex commercial disputes. She represents corporate policyholders in insurance coverage disputes involving matters such as management, product, and environmental liability claims.

As a leader in our insurance advisory and due diligence practice, Ariane successfully counsels clients on business and risk management issues. She advises clients with respect to negotiating and purchasing representation and warranty insurance, buy- and sell-side transactional due diligence, and annual insurance program renewals, including analyzing program and policy enhancements. Ariane has broad experience with all types of commercial insurance, including more than a decade of experience representing and counselling policyholders with respect to pursuing and resolving disputed claims.

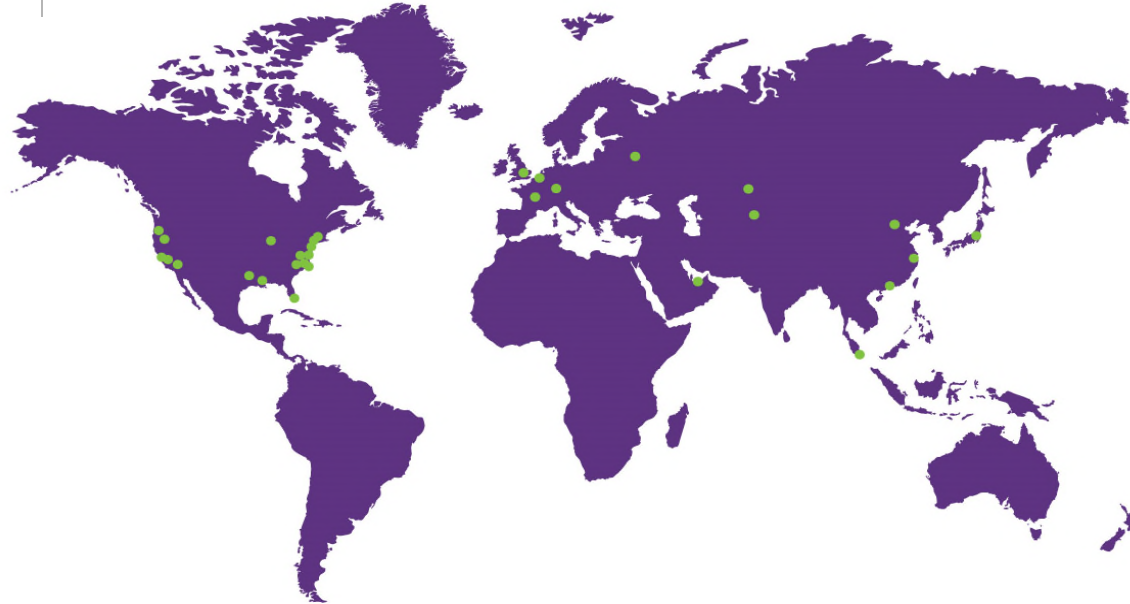
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