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Representations and Warranties Insurance in M&A Transactions

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The use of representations and warranties insurance in merger and acquisition transactions has grown tremendously in recent years. This article, which updates and expands on the author's previous analysis, explains what RWI is, what it's used for, and how it works.

Defining RWI

RWI is insurance that provides protection against losses that result from breaches of the representations and warranties in an acquisition agreement. RWI policies typically also provide coverage for losses resulting from breaches of the sellers' indemnities for pre-closing taxes of the target company, or if the acquisition agreement doesn't provide for such indemnities, the RWI policy will provide a "synthetic" indemnity for such taxes.

To date, RWI has been used most frequently in acquisitions of private company targets. Its use in public company deals has been less common, although it does seem to be increasing. One reason it is less common in public company acquisitions is that public company shareholders typically have no liability for indemnification after the closing, which means they have no motivation to obtain or to require a buyer to obtain RWI. Another reason is that as deal sizes increase, the effect of RWI becomes attenuated, although primary and excess coverage layers can be stacked to create a "tower" of coverage aggregating to hundreds of millions of dollars.

At the other end of the scale, there is some effective minimum enterprise value of the target company, given that a policy limit below $5 million generally isn't cost-effective.

Increasing Popularity

The increased usage of RWI in recent years is attributable to a combination of "macro" factors relating to the M&A market generally and some "micro" factors relating to RWI itself. The hot sellers' market of recent years has given sellers the leverage to demand both premium prices and minimal exposure to indemnification claims. At the same time, buyers, who are paying for deals that are "priced for perfection," are reluctant to incur additional downside risk. This buyer problem has been exacerbated by the fact that the acquisition process and timeline have been greatly accelerated and truncated in recent years, leaving less time for diligence and increasing the risk of unpleasant post-closing surprises.

At the same time, RWI itself has become a more attractive product. Policy pricing has decreased dramatically, to a range of 2.25% to 4%. In addition, the underwriting process has been standardized and accelerated—the whole process can be completed in a week or two if need be—and policy terms have significantly improved from the insured's perspective.

Types of RWI Policies

There are two basic types of RWI policies: Buyer policies and seller policies. Under a buyer policy, the buyer is the insured. In the event of a breach of a covered seller representation, the buyer makes a claim against the insurer and the insurer pays the buyer for the losses the buyer has incurred because of the sellers' breach. Under a seller policy, the sellers are the insureds. If the sellers incur a liability to the buyer for breach of their covered representations, the sellers pay the buyer but then can make a claim against the insurer for reimbursement.

Buyer policies have some advantages over seller policies, including broader coverage. A buyer policy will cover losses resulting from seller fraud. A seller policy, on the other hand, won't cover seller fraud. To do so would reward the sellers for their own bad behavior.

A buyer policy can extend the time period during which the buyer has recourse to at least three years for "non-fundamental" representations—(the vast bulk of representations are non-fundamental) and six years for "fundamental" representations and pre-closing tax indemnities. These policy periods run from the earlier of the signing of the acquisition agreement or the closing of the transaction. A seller policy only extends coverage for so long as the sellers are on the hook to the buyer, which in most deals, and for most representations, is a substantially shorter period of time.

A buyer policy also can increase the maximum amount the buyer can recover for breaches of representations. In a seller policy, the policy limit will be no greater than any applicable contractual cap on the sellers' liability. In a buyer policy, the policy limit can be greater than the cap on the sellers' liability; and in practice, it usually is.

For these reasons, in recent years, the vast bulk of RWI policies have been buyer policies.

Policy Terms

The coverage amount for RWI usually will be at least $5 million (lower limits are available, but will generally cost almost as much as a $5 million policy). For most deals, the premium cost will be somewhere between 2.5% and 3% of the coverage amount. If the target business is particularly risky because its industry is highly regulated or its particular business simply involves an above-average amount of risk, the premium cost may be higher, up to as much as 4% of the coverage amount. The same is true for very small policies; the effective minimum policy cost is about $150,000 to $200,000. The cost of the policy may be paid by the buyer or the sellers, or shared by them in negotiated proportions. Like other economic terms, this is a matter of deal-by-deal negotiation.

Under RWI, the insured's retention (akin to a deductible, this is the aggregate amount of losses that parties other than the insurer must absorb before the policy provides coverage) is generally no more than 1% of the target company's enterprise value. The retention typically will be reduced after 12 months, which generally corresponds with the period of time after which in an insured deal the indemnification escrow breaks and the sellers are off the hook for indemnification for breaches of non-fundamental representations. As with the premium cost, the buyer and sellers can negotiate how to allocate the retention between themselves.

For example, the buyer and sellers might agree to split the retention 50-50. If the retention was $1,000,000, as it might be for a hypothetical $100,000,000 deal, the buyer might agree to absorb the first $500,000 of losses through an indemnification deductible that applies to the sellers' liability for breaches of non-fundamental representations, and the sellers might agree to absorb the next $500,000 of losses through an escrow of sale proceeds. After that, the $1,000,000 retention would be fully eroded and the policy would kick in to provide coverage for covered losses, up to the policy limit.

While insurers generally prefer that sellers have a financial interest in making sure that their representations are true, most insurers these days will underwrite RWI for deals in which the sellers have no post-closing liability except for fraud. Under these policies, the policy premium tends to be a bit higher than in deals in which the sellers have some post-closing liability for breaches of representations, but the incremental cost is generally immaterial.

A buyer RWI policy typically will provide coverage for up to six years after the earlier of the signing of the acquisition agreement or the closing of the transaction. Most policies these days draw a distinction between the coverage period for fundamental representations, generally six years, and the coverage period for non-fundamental representations, which might be, say, three years. (Not too long ago some policies provided a six-year coverage period for both fundamental and non-fundamental representations, but that generally has not been the case in the last few years. This is one of the very few cases in which policy terms have changed in a manner adverse to insureds in the last few years, although based on very recent experience, it may be changing back.)

Why RWI?

Sellers like RWI because it can be used to limit—or even eliminate—their liability for indemnification for breaches of representations and certain tax indemnities. It also can be used to lower the amount of escrows or holdbacks of sale proceeds, and to shorten their duration. All of this reduces the likelihood of the sellers having to give back a portion of their sale proceeds. It also facilitates and accelerates the distribution of the sale proceeds to seller stakeholders and so increases their return on investment, which is desirable to any seller, and particularly so to private equity funds and other financial investors.

This can be particularly important in certain cases; for example, where the sellers include public shareholders, employee stock ownership plans (*ESOPS*), or certain trusts, all of whom typically cannot or will not provide indemnities, and to investment funds nearing the end of their lifespans, who want to liquidate their holdings, distribute the proceeds to their investors, and dissolve.

Lowering the risks for both sides can mean fewer issues and sticking points in negotiating the acquisition agreement, which can help to expedite the negotiations and increase the likelihood of getting to a signed acquisition agreement and a closing.

Buyers, on the other hand, like RWI because it can augment—or even completely replace—the sellers' indemnities. This can give the buyer an advantage in a competitive auction situation: The ability to offer more seller-favorable indemnity terms can distinguish the buyer's bid if other bidders aren't using RWI. More frequently it simply levels the playing field, because other bidders are using RWI. In auction scenarios, sellers or their bankers frequently will advise potential bidders to confirm in their bids that they will obtain RWI, and that the sellers will look with disfavor on any bid that doesn't. Sellers may even pre-qualify the target company with insurers and include information about available coverage in their auction materials.

Buyers also like RWI because it tends to make collecting indemnification easier and more certain. It's generally believed to be easier to collect from an insurer, who is a repeat player in the M&A marketplace and can't afford to get a reputation for unreasonably denying claims, than to chase sellers, who generally don't share that concern. RWI also can also permit a buyer to do a deal with sellers who can't or won't agree to meaningful indemnification, such as the public company shareholders and ESOPs mentioned above; or financially distressed sellers who are willing to agree to indemnify, but whose creditworthiness is suspect.

Where the sellers include persons who'll be involved in management of the target company post-closing, as is frequently the case with private equity and other financial buyers, RWI can help avoid putting the buyer to a choice between suing its management team or forgoing a portion of the buyer's losses. The same would apply to other "friendly sellers," such as other institutional investors with which the buyer has, or hopes to have, business relationships.

Effect on Acquisition Agreements

RWI hasn't changed every aspect of acquisition agreements. Sellers still make representations about the business they're selling, and those representations still consist of a relatively limited number of "fundamental" representations (for example, with respect to title, taxes, and capitalization) and many more "non-fundamental" representations about other aspects of the target business. Sellers still will have some level of liability for breaches of their representations, at the very least for fraud in the making of the representations.

But in insured deals, some related indemnification concepts have changed. For example, in a typical (if there is such a thing) non-insured deal, the parties would negotiate at length over the scope of the sellers' representations and related indemnification provisions. They would probably negotiate an escrow or holdback of from 5% to 20% of the purchase price, which would last for somewhere between 12 and 24 months. The escrow or holdback might or might not represent the buyer's sole recourse for breaches of non-fundamental representations.

In an insured deal in which the sellers have at least some post-closing liability for breaches of representations, the escrow or holdback amount likely would be much lower than in a non-insured deal—typically no more than the RWI policy retention or some agreed portion of that—and would last for only 12 months after the closing. The escrow or holdback almost always would represent the buyer's sole recourse for breaches of non-fundamental representations.

The sellers would still negotiate the scope of the representations, but given that the scope of the representations will determine the coverage of the RWI, and that the sellers will have very limited liability for breaches of most representations, the buyer likely will get a broader scope of representations, more quickly and with less fighting, than it would in a non-insured deal. The same is true (and for the same reason) with respect to full materiality "scrapes" (provisions for ignoring materiality qualifiers in representations for purposes of determining whether they've been breached and quantifying resulting losses) and broad definitions of indemnifiable damages (without exclusions for incidental or consequential damages, lost profits, etc.). Because the RWI policy will "follow the form" of the acquisition agreement with respect to both of these concepts, they have become completely standard in acquisition agreements for insured deals, and a reasonable seller won't put up any serious resistance to either.

In a typical insured deal, then, the sellers' liability is "a mile wide, but an inch deep." The buyer gets a comprehensive set of representations that are fairly broad, tough, and tight, a full materiality scrape, and a broad definition of indemnifiable damages, all with a lot less fighting and back-and-forth with the sellers than in a non-insured deal, but the sellers' liability for breaches of non-fundamental representations (which constitute the vast bulk of the representations) is very limited. RWI bridges the gap.

What is Covered/Not Covered?

Typically, absent particular diligence gaps or concerns, RWI will cover all of the representations in a typical acquisition agreement, including both fundamental and non-fundamental representations. Most policies also provide coverage for losses resulting from breaches of the typical pre-closing tax indemnities in the acquisition agreement.

Coverage will always be excluded for any known problems. For this purpose, an RWI policy will expressly provide that the relevant knowledge will be that of certain buyer deal-team members (typically a handful or fewer, and not including outside advisers) who will be specifically identified in the RWI policy, and the insurer will bear the burden of proving that at least one of these persons had actual knowledge both of the underlying facts and circumstances and that those facts and circumstances constituted a breach of a covered representation.

Coverage may also be excluded for any diligence gaps—matters as to which the insurer isn't satisfied with the scope of the buyer's diligence. The insurer will do its own diligence to some degree, but this tends to be fairly limited. For the most part the insurer piggybacks on the buyer's diligence. This includes receiving and reviewing copies of written diligence reports from the buyer's counsel, accountants, tax advisers, and other advisers, followed by a conference call including the insurer, its outside counsel, the buyer, and the buyer's advisers at which the insurer and its counsel can discuss any issues raised by the diligence reports or the insurer's own diligence and ask questions of the buyer and its advisers.

Other typical exclusions include losses covered by other insurance (RWI is excess, not primary); purchase price adjustments; covenants, estimates, projections, and other forward-looking information; liabilities for unfunded or underfunded benefit plans; non-monetary relief such as injunctions; and certain environmental hazards such as asbestos and polychlorinated biphenyls.

If the insured transaction doesn't involve a simultaneous signing-and-closing, the RWI policy also will exclude coverage for interim breaches. An interim breach is a breach of a covered representation that occurs and of which the buyer's deal team actually becomes aware between the signing of the acquisition agreement and the closing of the deal. As with the exclusion for breaches “known” prior to the inception of coverage, the insurer will bear the burden of proving that at least one of the buyer's specified deal-team members obtained actual knowledge during the post-signing, pre-closing period both of the underlying facts and circumstances and that those facts and circumstances constituted a breach of a covered representation. Unlike other, insurable risks, the buyer and the seller need to allocate the risk of interim breaches between them as a matter of contract, through appropriate covenants, conditions, and indemnities.

As this article goes to print, in the spring of 2020, various forms of a new type of exclusion have begun appearing with respect to losses caused or exacerbated by the Covid-19 coronavirus. At present, the situation is fluid, to say the least, and the scope of the proposed exclusion varies widely—and as with most things in the RWI world, is negotiable. Depending on the success of efforts to contain and combat the virus, its effects on specific industries and on the economy generally, and the insurance industry's ability ultimately to quantify and price the risks it presents, this exclusion may prove to be a temporary or limited phenomenon, or not. If not, over time the scope of the exclusion likely will become fairly standardized. For now, in any event, it's being negotiated on a case-by-case basis.

‘Rollover’ Equity

One of the ways RWI policy terms have improved for insureds in the last few years is in the case of rollover equity. If some or all of the sellers in an M&A transaction are going to have a substantial equity stake in a buyer entity (as is often the case in private equity transactions), the insurer will be concerned that the sellers may profit, by sharing in insurance proceeds, for their own lack of diligence, or worse, in avoiding breaches of their representations in the acquisition agreement. The buyer may be able to structure around the problem by making the named insured under the RWI policy an entity in which the sellers don't have an equity interest, such as a holding company that “sits above” the buyer entity in which the sellers will have an equity interest.

If a structural solution isn't practicable, the RWI policy may provide for reduction of policy payments to reflect the sellers' ownership interest. In that case, the buyer is going to want to negotiate an internal economic arrangement that allocates the full benefit of the insurance proceeds to equity participants other than the sellers.

As recently as a few years ago, if seller rollover equity constituted more than 20% or so of an insured buyer entity, insurers generally would require either a structural solution along the lines mentioned in the prior paragraph or that the policy provide for reduction of payments to reflect the sellers' ownership interest in the insured buyer entity. More recently, insurers have gotten more comfortable with insuring buyer entities in which the sellers' rollover equity is as much as 40%, or even more.

In those circumstances, to avoid reduction of policy payments, the insurer will require the sellers to sign a no-claims declaration similar to the one the buyer will need to sign upon signing of the acquisition agreement, and again on closing, if the deal doesn't sign and close simultaneously (which in essence simply certifies that the buyer's specified deal-team members, or the sellers, as the case may be, aren't actually aware of any breaches of the covered representations). The policy retention will be based on the overall enterprise value of the target business, not just the portion the buyer is effectively acquiring (as would generally be the case if the sellers' interest in the insured buyer entity was not benefiting from the insurance). And the policy premium may be slightly higher, albeit not materially so.

The RWI Process

If RWI makes sense for a deal, the following steps are needed to put it in place for the more common buyer policy.

***Sellers*: Ask for an Insured Deal**

Sellers will want to make clear to the buyer or to potential bidders in an auction or other competitive process that it expects an insured deal, ideally of the no-seller-liability variety. Failing that, the seller will seek an arrangement under which RWI is the buyer's main recourse, although there could also be some liability for indemnification, such as claims below the policy retention or above its coverage limit.

Ideally the sellers will want the buyer to bear the policy retention and premium cost. Alternatively, the seller may offer to split these with the buyer. In the current market, no one is going to be surprised by any of these requests, although they may want to negotiate a retention-split instead of a no-seller-liability deal, or a cost-split instead of a pure buyer-pays deal. Private-equity buyers have been doing it this way for upwards of a half-dozen years now, and more recently strategic buyers have grasped the "new math" and joined the bandwagon.

Negotiate Fraud Liability

The sellers will also want to negotiate their liability for fraud. As described above, the negotiation of many of the liability aspects of insured deals is much easier than it is in non-insured deals, but the issue of fraud—what it is and how it matters—still comes up in every deal, and in an insured deal, there's an additional consideration. An insurer who pays its insured is subrogated to the insured's rights against third parties, including the sellers. If the insurer could simply pay the buyer and then go after the sellers for reimbursement, it would defeat much of the purpose of the policy.

So the insurer will waive subrogation against the sellers, except in the case of "fraud," however defined. And it will be defined, because for purposes of the RWI policy it will have the same meaning as it does in the underlying acquisition agreement. Sellers therefore will want to make sure that, in both the acquisition agreement and the policy, "fraud" means intentional fraud in the making of the covered representations, and that liability for fraud is limited to those of the sellers who actually committed the fraud.

Most buyers will fairly readily agree that there must have been intentional fraud within the four corners of the acquisition agreement. The limitation of liability for fraud to the "fraudsters" themselves, and not innocent sellers, can be more controversial. While some buyers will agree to this, others will not. Where each of these issues ends up will be questions for negotiation between the buyer and sellers; for policy purposes, most if not all insurers will accept the same fraud limitations that the buyer does. Sellers should address these issues early on, when their negotiating leverage is highest—before granting exclusivity.

Stapled Insurance Not Necessary

Some sellers in auction scenarios have adopted a "stapled insurance" procedure in which they solicit indications of interest from potential insurers and include these with their auction materials to potential bidders, but this procedure isn't common anymore. Probably it was a reflection of the corporate-control marketplace of a few years back, when knowledge and usage of RWI were less common than they are today and a seller might worry that potential bidders, particularly strategic buyers, would shy away from participating in an auction out of ignorance of how RWI worked in general or doubt as to whether it would be available for a particular target.

The likelihood of each of these possibilities has declined. Most regular participants in the M&A market, including both financial and strategic buyers, are quite familiar with the RWI product and process these days, and the RWI marketplace has become so large and competitive that RWI is available for all but the riskiest target businesses and deals.

Buyer's Broker Canvasses RWI Market

A buyer's first step is to contact an insurance broker, provide the broker with some basic information about the target business such as any offering documents including confidential information memorandum and financial statements (audited if available), and ask them to solicit indications of interest from the RWI marketplace. This will generally result in a number of non-binding indications of interest or NBILs from insurers potentially interested in underwriting RWI for the deal.

The NBILs will lay out not only the proposed economics of coverage—policy limit, premium cost, and retention—but also proposed coverage exclusions and areas of "heightened underwriting scrutiny." The economics usually will be relatively consistent, although there can be outliers, new or otherwise underutilized insurers willing to be aggressive on pricing and other terms to win business, or insurers who have dominant market positions or who are too busy already, who really don't want the business unless the terms are really attractive to them.

The exclusions and heightened-scrutiny matters, on the other hand, can vary widely, and these differences sometimes provide a meaningful basis for selecting an insurer. Proposed exclusions and heightened-scrutiny matters can be negotiated to some extent, particularly, changing per se exclusions to areas of heightened-scrutiny, meaning that the insurer is willing to be open to eliminating a proposed exclusion if satisfied with the scope and results of the buyer's diligence.

Once the buyer selects an insurer, it will engage the insurer and pay it a diligence fee (typically $25,000 to $35,000), which is intended to cover the insurer's expenses of engaging outside counsel and allocating internal underwriting resources to diligence the target business and to craft an appropriate RWI policy. Some insurers won't engage with a bidder that doesn't have exclusivity, for fear that that bidder won't win the deal and the insurer won't be able to underwrite RWI for the winning bidder because of conflict and confidentiality concerns. Other insurers will engage pre-exclusivity, for a fee, which will be credited against the policy premium if the bidder wins the auction and purchases a policy.

The insurer will need to receive and review copies of all written diligence reports prepared by the buyer and its outside advisers—legal, financial/accounting (quality-of-earnings or the like), tax, other specialists, etc.—pursuant to standard non-reliance agreements by which it agrees that it cannot rely on or sue the report-preparers based on the reports. Once it has done so, it will schedule a diligence call among the insurer and its outside counsel and the buyer's deal team and outside advisors to go through diligence issues and questions. This is generally a several-hour call that can range from a very detailed "deep-dive" to a superficial box-checking exercise. Typically, the call will result in a punch-list of follow-up questions that the buyer and its advisors need to respond to before the insurer will issue an RWI policy without exclusions based on diligence-gaps.

The insurer will produce a draft policy in a form previously negotiated between the insurer and the buyer or its broker or counsel, so changes, other than any deal-specific ones, likely will be minimal. The policy will be bound at the signing of the acquisition agreement, with the premium payable within ten days or so; or if the closing is deferred, a non-refundable deposit of 10% of the premium will be due after signing, with the balance due after closing.

As mentioned above, the buyer (and in the case of a significant seller rollover for which the RWI policy provides coverage, also the sellers) will need to deliver a no-claims declaration in connection with the signing of the acquisition agreement, and if there is a deferred closing, also in connection with the closing. The buyer also will need to provide the insurer with a copy of the sellers' final electronic dataroom on a thumb drive or other storage medium.

RWI Policy Terms

As mentioned above, these days it's most common for the insurer's first draft of an RWI policy to be based on a policy form previously negotiated between the insurer and the buyer or its broker or counsel, so non-deal-specific changes to the draft will be minimal since most of the policy language will already have been negotiated. Indeed, for the most part even the insurers' standard forms already incorporate insured-favorable concepts and language that as recently as a few years ago had to be negotiated individually but now have become "market-standard."

One provision sometimes included in insurers' draft policies is a requirement to arbitrate any coverage or other disputes between the insurer and the insured. But arbitration proceedings can be (and usually are) kept confidential, unlike judicial proceedings; so that if an insurer unreasonably resists paying a legitimate claim, the RWI market is less likely to find out about it.

Given the high level of competition in that market, an insurer won't want to get a reputation for unreasonably resisting paying legitimate claims (this is one reason for the general belief that it's easier to collect from an RWI underwriter than sellers), and so may act more reasonably in resolving coverage disputes if the alternative is public litigation rather than private arbitration. Insureds therefore should insist on having the option to litigate, rather than arbitrate, claims disputes. Most insurers will agree to this.

Caveat

This article is only a brief introduction to the use of RWI in M&A transactions. Parties interested in using RWI in an M&A transaction should ensure that among themselves and their professional advisers, particularly their insurance broker and legal counsel, they collectively have a substantial degree of expertise and experience in doing insured deals, which involve considerations and nuances that are beyond the scope of this article.