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MERGER AGREEMENTS

BNA Insights: Representations and Warranties Insurance in M&A Transactions

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In recent years, the use of representations and warranties insurance (*RWI*) in M&A transactions has grown tremendously. What is RWI; what's it good for; and how does it work?

What is RWI? RWI is insurance that provides protection against losses that result from breaches of the representations and warranties (simply referred to as ''representations'' in the rest of this article) in an acquisition agreement. Some RWI policies also provide coverage for losses resulting from breaches of certain of the tax indemnities in the acquisition agreement.

RWI is mostly used in acquisition of private company targets; its use in public company deals is rare. One reason is that in most public company acquisitions the sellers have no liability for indemnification after the closing, which means the sellers have no motivation to obtain or require a buyer to obtain RWI. It also means that some insurers are going to be more reluctant to underwrite RWI for a public deal, because insurers prefer that both buyer and sellers having meaningful ''skin in the game'' to ensure that both are economically motivated to avoid breaches—although, as mentioned below, some insurers will underwrite RWI for deals in which the sellers have no post-closing liability for breaches of representations absent actual fraud in the making of those representations.

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Another reason is that RWI is typically used in deals where the acquired company has an enterprise value not greater than $3 billion; beyond this deal-size the effect of RWI becomes attenuated as in the current market there is an effective maximum policy limit of about $50,000,000 per insurer. Although policies from multiple insurers can be ''stacked'' to provide additional coverage, aggregate coverage amounts above $300 million are rare. At the other end of the scale, the effective minimum enterprise of the target company is about $20 million. Below this, realistic policy sizes, and so premiums, are not large enough to attract much interest from insurers.

Why has RWI become so popular? The growth in the use 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; while 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. Not that long ago, the premium cost of RWI was up to 10% of the coverage amount; today it's generally 3% to 4%. In addition, the underwriting process has been standardized and accelerated — the whole process can be completed in one to three weeks — 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 fraud by the sellers in the making of their representations. A seller policy will not 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 for breaches of representations, typically to up to three to six years after 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, most RWI policies issued have been buyer policies.

Policy terms. The coverage amount for RWI generally will be at least $5,000,000. The maximum coverage amount for a single insurer is about $50,000,000, but additional coverage may be available by ''stacking'' policies from multiple insurers. Premium cost is generally around 3% to 4% of the coverage amount. 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 from 1% to 2% 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. A buyer and sellers can negotiate how to allocate the retained risk represented by the retention between themselves in almost any manner they choose. Insurers generally prefer that both sides have some skin in the game, but some insurers will underwrite RWI for deals in which the sellers have no post-closing liability for breaches of representations absent actual fraud in the making of those representations. Under these policies, the retention—which is borne entirely by the buyer—tends to be a bit higher (by 30 to 50 basis points) than is the case where the sellers have some post-closing liability for breaches of representations.

For example, the buyer and sellers might agree to split the retention 50-50. If the retention was $1,500,000, as it might be for a hypothetical $100,000,000 deal, the buyer might agree to absorb the first $750,000 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 $750,000 of losses through an escrow of sale proceeds. After that, the $1,500,000 retention would be fully eroded and the policy would provide coverage for covered losses, up to the policy limit.

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. Some policies will draw a distinction between the coverage period for fundamental representations, generally six years, and that for non-fundamental representations, which might be, say, three years. Other policies will provide a six-year coverage period for both fundamental and non-fundamental representations.

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. This is desirable to any seller, and especially 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, 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 may advise potential bidders that they expect bidders to confirm in their bids that they will obtain RWI, and that the sellers will look with disfavor on any bid that does not do so. Sellers may even prequalify 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 easier collecting from the insurer than it is chasing sellers. RWI also can also permit a buyer to do a deal with sellers who can't or won't agree to meaning-

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ful indemnification, like 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 will 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.

Use of RWI has changed deal terms in acquisition agreements. Some things haven't changed. 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 usually—although not always—have some level of liability for breaches of their representations.

But 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 1% of the purchase price—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.

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, and generally with a lot less fighting and back-and-forth with the seller 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? What is 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. Depending on the policy, it may also provide coverage for losses resulting from breaches of certain of the tax indemnities in the acquisition agreement.

Coverage will be excluded for any known problems. Coverage may also be excluded for any ''diligence gaps,'' *i.e.*, matters as to which the insurer is not 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 reviwing 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.

A special buyer concern — ''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.

A special seller concern - subrogation. An insurer who pays a loss for its insured is subrogated to its insured's rights against third parties in respect of the loss. If the issuer of RWI could simply pay an insured buyer's claim and then go after the sellers, however, it would defeat much of the purpose of the policy; so in a buyer policy, the insurer will waive subrogation against the sellers except in the case of seller fraud. The sellers will want to make sure the policy is clear that this means actual fraud in the making of the covered representations, not some lesser degree of wrongdoing such as negligent or constructive fraud.

Conclusion. This article is intended only as 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 involves considerations and nuances that are beyond the scope of this article.