



Morgan Lewis

**M&A ACADEMY:  
THIRD PARTY REPRESENTATIONS  
AND WARRANTIES INSURANCE IN  
STRATEGIC AND PE DEALS**

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December 12, 2017

# 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
- Reps & Warranties impact indemnification and closing/termination

# Reps & Warranties Insurance Overview

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

- Protects the insured from unanticipated (unknown) losses that may arise subsequent to the closing
- Absent diligence gaps or concerns, Reps & Warranties insurance generally covers all Reps & Warranties in the purchase agreement as well as certain tax indemnities
  - Coverage will be excluded for known problems or where the insurer is not satisfied with the scope of buyer's diligence
- Either buyer or seller can be the insured under the policy
  - Buyer policies typically provide broader coverage (for example, fraud and longer survival periods)

# Transactional Risk Insurance Overview

## 2016

- \$6.03 billion in limits / 212 closed deals

## 2015

- \$4.26 billion in limits / 159 closed deals

## 2014

- \$2.73 billion in limits / 130 closed deals

## 2013

- \$1.34 billion in limits / 66 closed deals

## 2012

- \$1.43 billion in limits / 51 closed deals

## 2011

- \$767 million in limits / 45 closed deals

## 2010

- \$387 million in limits / 25 closed deals

## Global Market Statistics for 2016 (Marsh only)

US\$	AMERICAS	EMEA	ASIA PACIFIC	TOTAL
Limits of insurance placed (\$)	6,025,000,000	6,422,000,000	2,276,000,000	14,723,000,000
No. of policies placed	280	190	86	556
Private equity policies (as % of policies placed)	56%	52%	53%	54%
Corporate policies (as % of policies placed)	44%	48%	47%	46%
Seller-side R&W policies (as % of R&W policies placed)	1%	4%	7%	3%
Buyer-side R&W policies (as % of R&W policies placed)	99%	96%	93%	97%

# Current Market for R&W Insurance

## Markets:

- New entrants in the market driving competition and, as a result, reducing costs
- 19 primary underwriters in market
- Total Capacity: up to ~\$1 billion in coverage limits available

**Activity in 2016:** Over 1,000 R&W insurance policies were placed in North America in 2016, and in excess of 1,500 globally.

**Coverage Terms:** Policy terms are better aligned with acquisition agreements and underlying indemnification provisions (knowledge, scope of damages, removal of subject matter exclusions, lower pricing and overall better policy terms available).

**Pricing:** Generally in range of 2.25% to 3.5% of coverage limits. Recent decline in pricing due to increased competition in the market.



# R&W Insurance – Basics

<b>Coverage:</b>	Typically covers full set of negotiated reps & warranties relating to the target company and selling shareholders, including tax matters.
<b>Knowledge:</b>	Implications for Buyer-side and Seller-side policies.
<b>Capacity:</b>	Limits up to ~\$1 billion available in current market.
<b>Pricing:</b>	Generally 2.25% to 3.5% of limits in current market (i.e., \$225,000 to \$350,000 per \$10 million in protection).
<b>Policy Period:</b>	Up to 6 years.
<b>Retention:</b>	Minimum 1% to 2% of the transaction value on most transactions (drop downs often available).
<b>Standard Exclusions:</b>	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.
<b>Deal Specific Exclusions:</b>	Exclusions may be proposed at non-binding indication stage (FLSA/Wage & Hour, Cyber/Data Security, Product Liability, Warranty, Recall, S-corp election, etc.) or based on diligence findings (identified/known issues or insufficient scope of diligence).

# R&W Insurance – Typical Uses

Buyers	Sellers
Risk Management Uses	Risk Management Uses
<ul style="list-style-type: none"> <li>• Increase maximum indemnity / extend survival period for breaches of reps &amp; warranties</li> <li>• Elimination of seller post-closing credit risk</li> <li>• Provide recourse when no seller indemnity possible (public company sales, bankruptcy)</li> </ul>	<ul style="list-style-type: none"> <li>• Reduce contingent liabilities</li> <li>• Distribute sale proceeds</li> <li>• Protect passive sellers</li> </ul>
Strategic Uses	Strategic Uses
<ul style="list-style-type: none"> <li>• Distinguish bid in auction</li> <li>• Protect key relationships</li> </ul>	<ul style="list-style-type: none"> <li>• Attract best offers by maximizing indemnification</li> <li>• Include R&amp;W insurance as the sole remedy in draft agreements in auctions</li> </ul>

# R&W Insurance Replaces Seller's Risk





# R&W Policy Structure

## Buyer Policy

*First party indemnity policy structure* – covers loss resulting from breaches discovered during the policy term

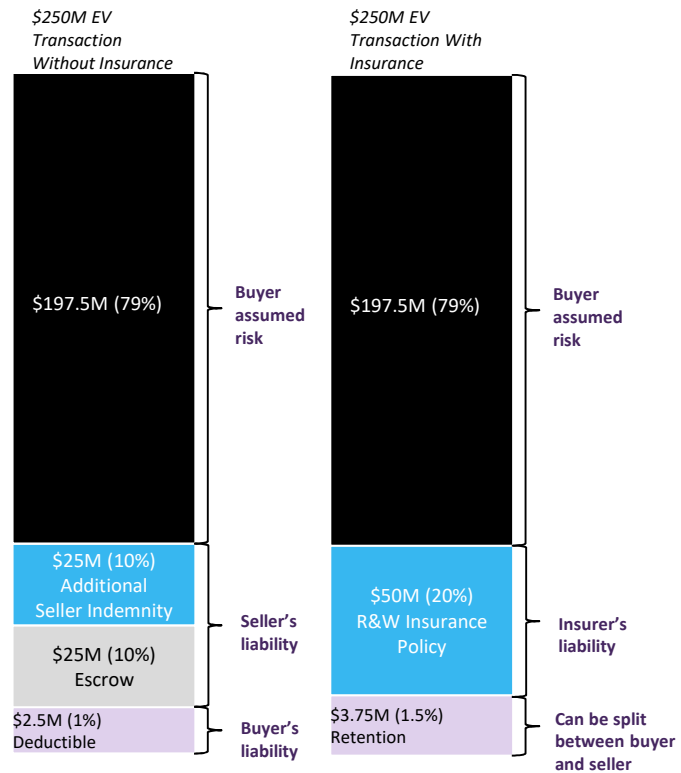
- Extends survival periods beyond acquisition agreement (can be tailored to meet needs of parties out to as long as 6 years)
- Increases indemnification above seller cap

## Seller Policy

*Liability policy structure* – covers claims made against the sellers alleging breach of representations and warranties

- Generally follows caps and survival periods in acquisition agreements (to maximum of 6 years)
- Fraud / Dishonesty Exclusion – Sellers cannot insure against their own fraud
- Can be structured to protect passive investors in some situations even if management acted fraudulently

# Reps & Warranties Insurance – Sample Scenario



## Background

- Buyer: US private equity firm
- Target: Distribution company
- Seller: US private equity firm
- Enterprise value: \$250 million

## Issue

- Buyer wanted to differentiate its bid in a highly contested auction
- Seller wanted a clean exit at closing to maximize closing date proceeds

## Solution

- Buyer-side reps & warranties insurance policy
- Limit: \$50 million
- Premium: \$1.8 million
- Policy term: 3 years for general reps / 6 years for fundamental and tax reps

# Reps & Warranties Insurance: Underwriting Process

## Days 1 – 2

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

**Note:** Insurers need to understand exclusivity arrangements on transaction (or lack thereof) – timing / financial impact on process

## Days 3 – 6

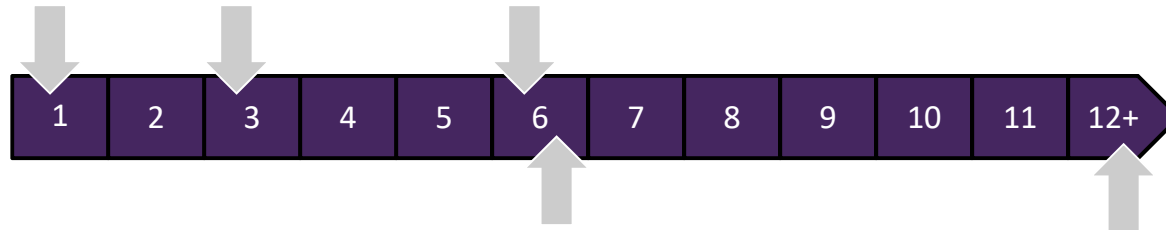
**Obtain quotes from underwriters**

- In order to get quotes, we would need recent 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+

**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

# Key R&W Policy Issues

## **Retention**

- Erosion structure with escrow (drop down / erosion for uncovered indemnification payments, etc.).

## **Definition of Loss**

- Seek to align as closely as possible with the acquisition agreement.
- Consequential, punitive and pricing multiple damages excluded in base forms (except for third-party claims) but typically negotiated such that policy and acquisition agreement are silent as to consequential and multiple type damages.

## **Materiality Scrape**

- Insurers typically will follow a materiality scrape where one exists in the acquisition agreement. Dialogue with insurers on scope of damages that can be insured on the transaction should be conducted early in the process.

## Key R&W Policy Issues (Cont.)

### **Interim Period Coverage on Split Sign and Close Deals**

- Coverage bound at signing – % of premium typically due at signing (non-refundable if transaction does not close), can cover unknown breaches as of signing.
- Interim breach coverage – new events between signing and closing not covered.
- 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.

# Strategic Considerations / R&W Policy Next Evolution

## Strategic Considerations

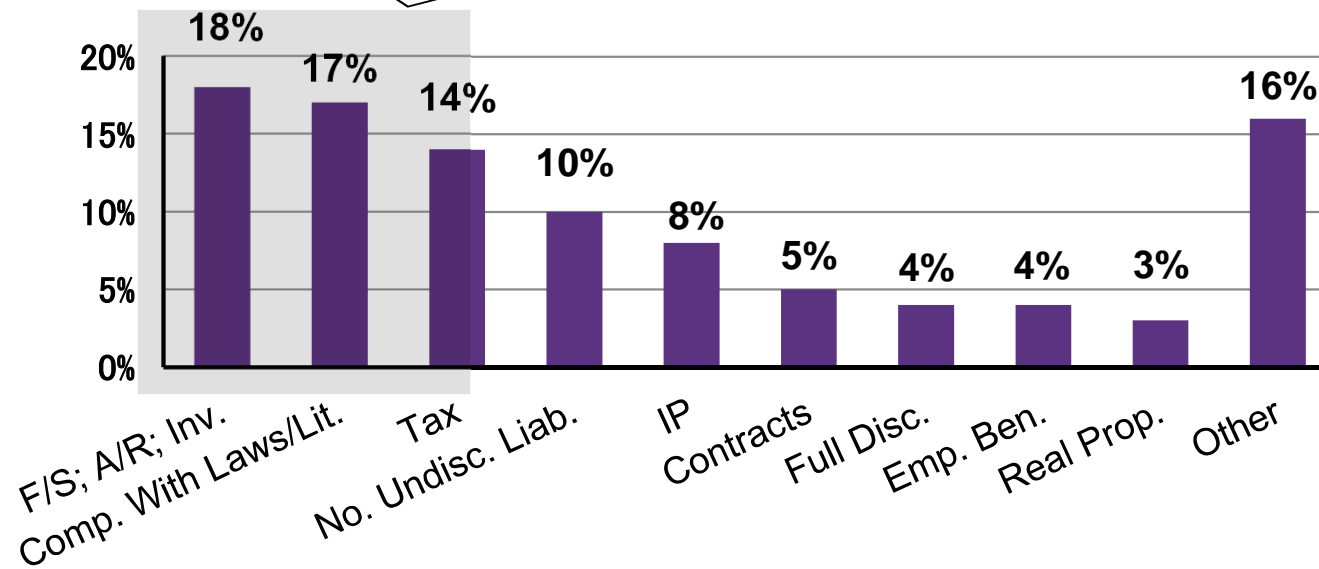
- While market is rapidly changing, some strategics are hesitant to embrace R&W insurance.
- Buy-side diligence approach
  - Team members
  - Diligence reports
  - Buyer 'comfort' on diligence on specific matters
- Insurance vs. M&A; opportunity to leverage existing insurance relationships

## Next Evolution

- Market trends already here
  - Continued expansion of product offering and coverage protection
  - Drop in pricing and growing insurer comfort on no seller exposure structure
- "Public style" deals
- Public deals

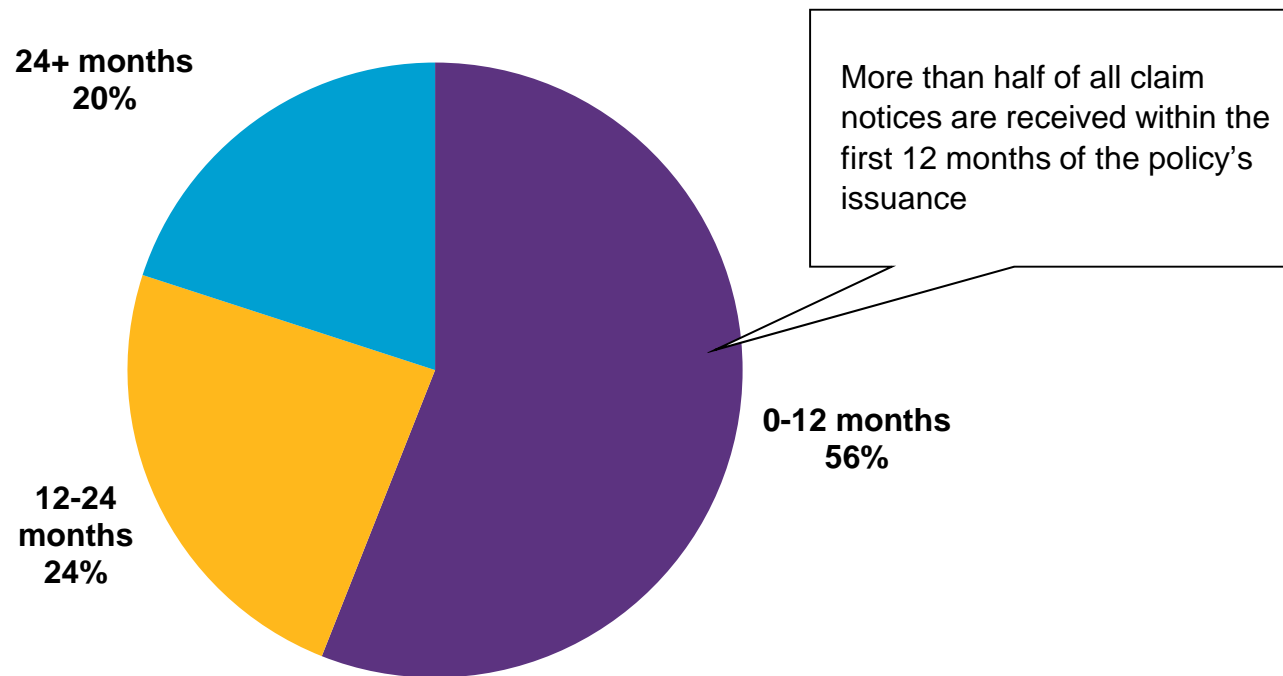
# R&W Claims

The R&Ws regarding financial statements, compliance with laws and tax are the most frequently alleged to have been breached



# Timing of Claims Reporting – North America

## Time Lapse Between Policy Inception and Receipt of Notice of Claim

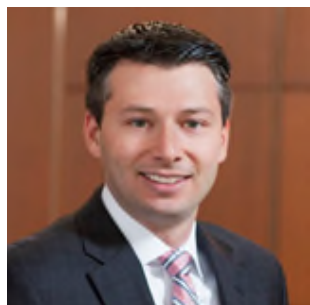






# Questions?

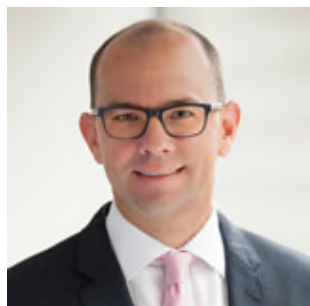
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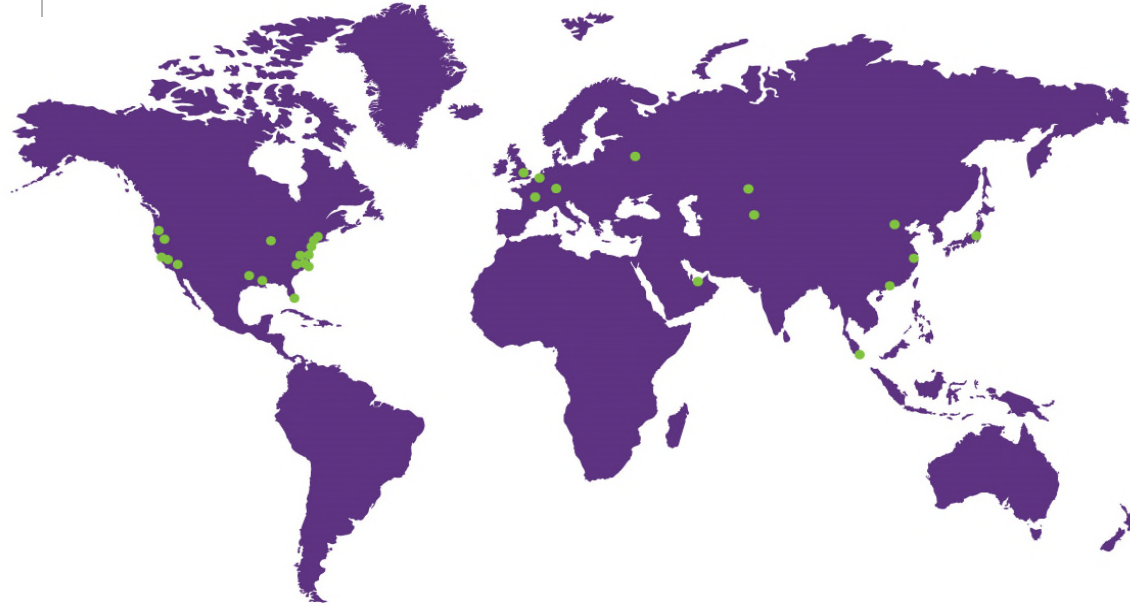
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