

A background image of a chessboard with a vertical split down the center. The left side is dark and the right side is light. Chess pieces are visible on the board, including a king, queen, and pawns. The text is overlaid on the left side of the board.

Morgan Lewis

M&A ACADEMY: THIRD PARTY REPRESENTATION AND WARRANTY INSURANCE IN STRATEGIC AND PE DEALS

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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

Representation & Warranty Insurance Overview

Created to facilitate M&A transactions by addressing indemnification issues. Provides coverage for financial losses resulting from breaches of representations and warranties made by target company or sellers contained in purchase agreement

- Representation and warranty insurance (or “R&W Insurance”) protects the insured from unanticipated (unknown) losses that may arise subsequent to the closing
- Generally covers all representations and 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

2017

- \$8.83 billion in limits / 303 closed deals

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 2017 (Marsh only)

US\$	AMERICAS	EMEA	ASIA PACIFIC	TOTAL
Limits of insurance placed (\$)	8,830,000,000	8,120,000,000	2,970,000,000	19,920,000,000
No. of policies placed	406	224	105	735
Private equity policies (as % of policies placed)	50%	56%	34%	50%
Corporate policies (as % of policies placed)	50%	44%	66%	50%
Seller-side R&W policies (as % of R&W policies placed)	2%	7%	9%	4%
Buyer-side R&W policies (as % of R&W policies placed)	98%	93%	91%	96%

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 2017: Over 2,000 R&W insurance policies were placed in North America in 2017, and in excess of 2,500 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

Coverage:	Typically covers full set of negotiated reps & warranties relating to the target company and selling shareholders, including tax matters.
Knowledge:	Implications for Buyer-side and Seller-side policies.
Capacity:	Limits up to ~\$1 billion available in current market.
Pricing:	Generally 2.25% to 3.5% of limits in current market (i.e., \$225,000 to \$350,000 per \$10 million in protection).
Policy Period:	Typically 3 years for general representations and warranties (up to 6 years for fundamentals).
Retention:	Minimum 1% to 1.5% of the transaction value on most transactions (drop downs often available after expiration of general survival period (12-18 month anniversary of closing)).
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 Uses

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

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

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 and punitive damages (except for third-party claims) and pricing multiple damages typically excluded.
- Consequential damages often negotiated such that policy and acquisition agreement are silent.

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 – ~10% of premium typically due at signing (non-refundable if transaction does not close), can cover unknown breaches as of signing.
- Interim breach coverage – new breaches discovered 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.

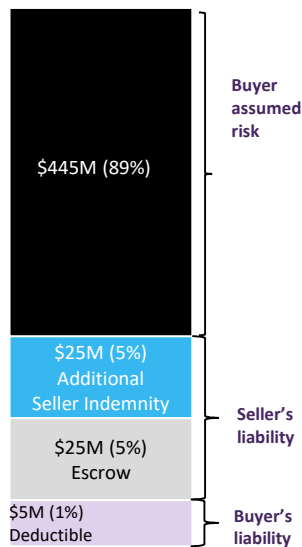
Costs

- Often fully loaded costs of policy are split 50/50 with seller as a transaction expense.
 - Surplus Line Taxes
 - Underwriter additional fee

Sample Seller Liability Models - \$500M EV Transaction

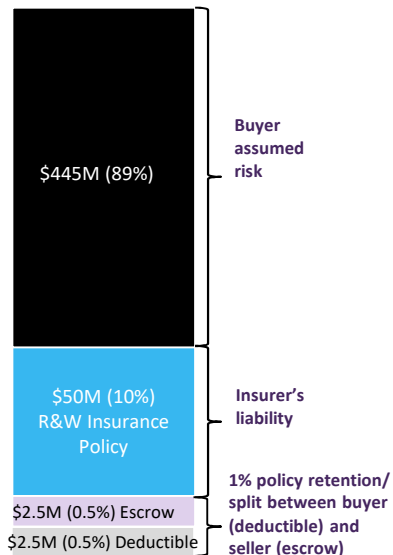
Seller Indemnity; No RWI

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



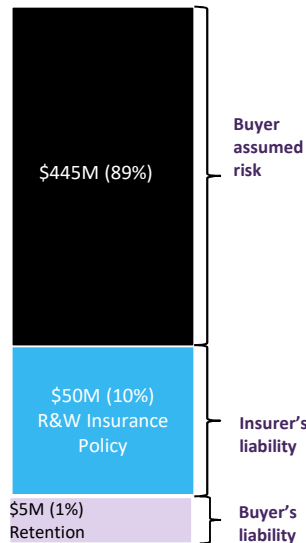
Seller Indemnity w/ RWI

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



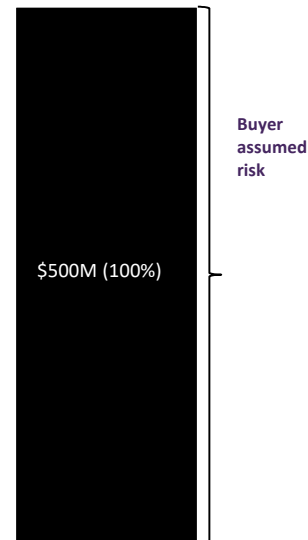
No Seller Indemnity w/ RWI

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

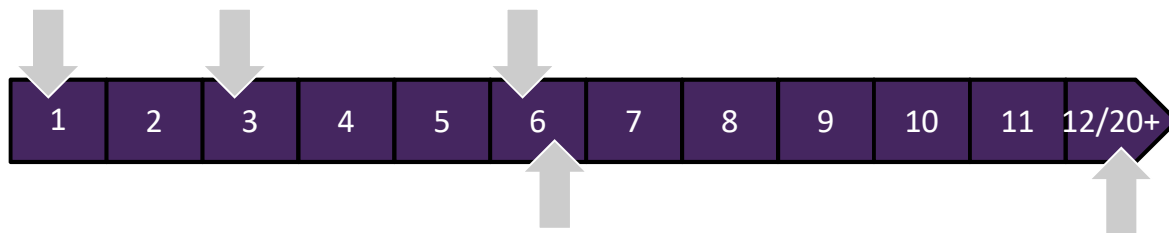
Broker obtain quotes (non-binding indications) from underwriters

- 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

- Often seller will do work ahead of time and give buyers non-binding indications (which seller has obtained) based on the auction form of purchase agreement
- Insurers need to understand buyer's transaction process and anticipated timing, in particular in an auction, so that underwriting process occurs within overall deal timeline. Considerations include:
 - 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
 - In an ideal scenario for insurers, underwriting process occurs when buyer has exclusivity with seller
 - Although market continues to evolve, it remains relatively uncommon to complete full underwriting when buyer is one of multiple bidders participating in bid stage of an auction process
 - If buyer chooses to complete full underwriting process pre-exclusivity, insurers may charge a "pre-exclusivity" fee to do so (although negotiable, fees range from \$65K to \$200K), fee is in addition to underwriting fee and is applied to the premium
 - With increased competition among insurers, approaches to this issue continue to evolve

Strategic Considerations / R&W Policy Next Evolution

Strategic Considerations

- While market is rapidly changing, some strategic buyers 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

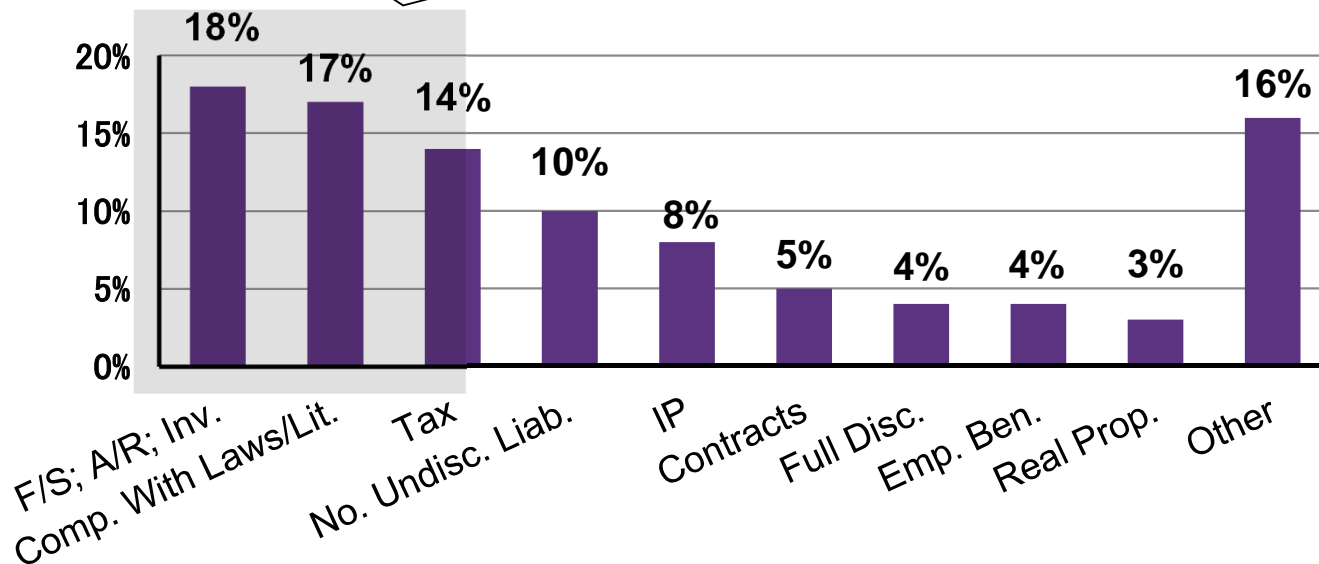
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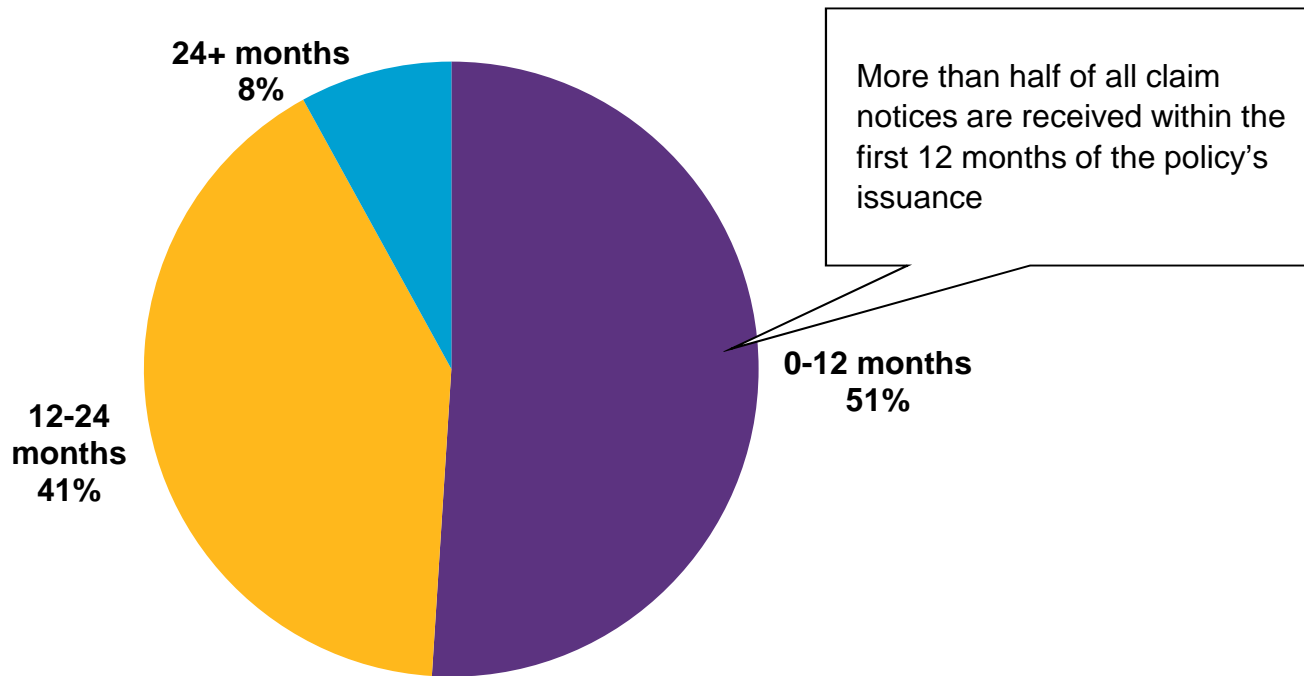
R&W Claims

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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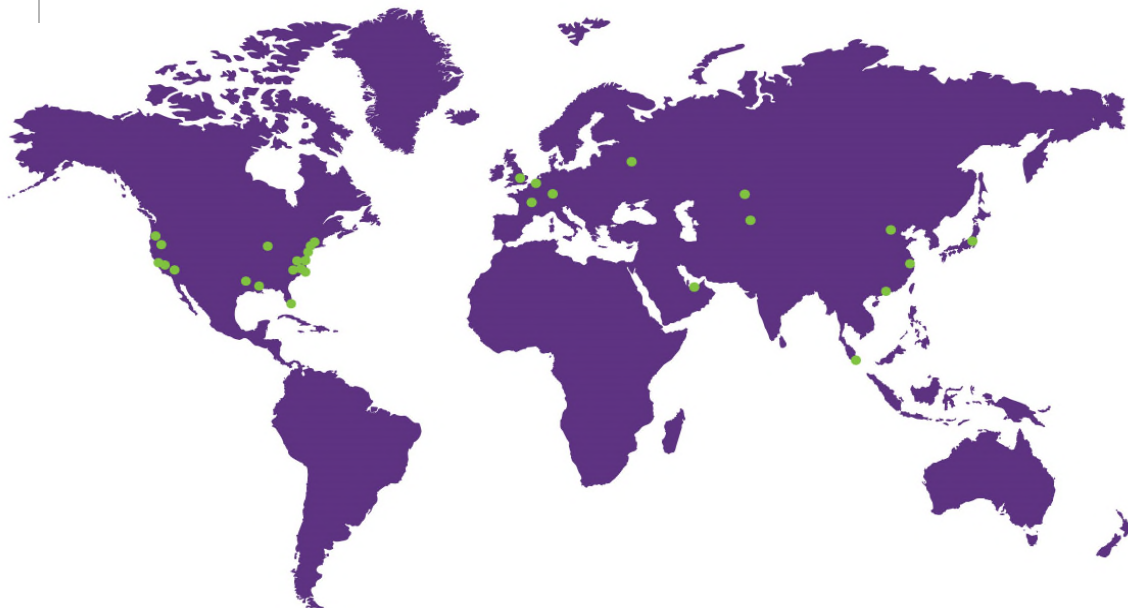
Mark L. Opitz represents private equity firms, public companies, venture capital funds, entrepreneurs, and emerging companies across many industries, including technology, manufacturing, and retail. He has experience in mergers and acquisitions, leveraged buyouts, strategic investments, recapitalizations, venture capital investments, joint ventures and governance matters. His experience includes transactions ranging from several million dollars to more than \$1 billion.

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