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M&A ACADEMY

Warranty and Indemnity Insurance: Reactions to COVID-19

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December 1, 2020

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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

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

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Key R&W Policy Issues

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.

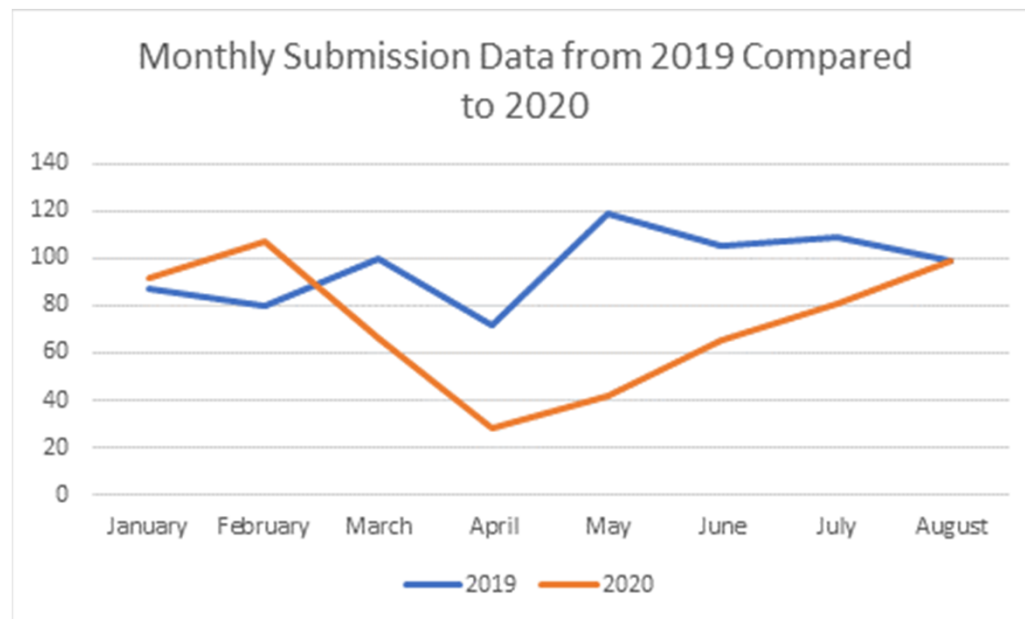
Costs

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

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2020 Market for R&W Insurance

- Aon estimates that 48% of North American M&A deals (defined as private transactions in the US\$25 million to US\$10 billion range) utilized R&W insurance in 2019, up from 40% in 2018.
- Q1 2020 had 30% less deal volume than Q4 2019.
- Q1 2020 had 25% less R&W volume compared to Q1 2019.
- Submission volume has since rebounded to 2019 levels as of August.



*Data from (1) Aon's "Global M&A and Transaction Solutions – Risk in Review 2020" Available at <https://www.aon.com/m-and-a-riskinreview/global20201h.aspx>, and (2) Aon's Transaction Solutions Senior Managing Director

COVID-19 R&W Underwriting Evolution

- The state of R&W underwriting related to COVID-19 is fluid.
- COVID-19
 - Initially a number of insurers proposed broad COVID-19 exclusions.
 - Most have now adopted a measured approach with COVID-19 as a heightened risk, generally resulting in some form of exclusion.
 - Common exclusion for third-party liability arising from transmission of virus.
 - Exclusions depend on operations and jurisdictions of the target.
- PPP Loans
 - Generally, insurers are unwilling to cover representations regarding PPP Loan matters.

COVID M&A Considerations that Impact R&W Insurance

- Definition of MAE
 - What is the breadth of the COVID-19 exception?
- Representations
 - Customers and Supplier relationships
 - Supply chain
 - Financial performance
 - Employment matters
 - Material contracts
 - Business continuity
 - Other insurance
- Due Diligence

Early COVID-19 R&W Exclusions

- arising from disruptions to the Company's **operations** or adverse effects on the Company's **customers or other counterparties** that are **directly attributable** to COVID-19, including, but not limited to (i) labor shortages, (ii) government enforced quarantines, (iii) reduction in customer demand or (iv) any force majeure events
- **any business interruption or other downturn** to the extent such interruption or downturn arises out of the presence, transmission, threat or spread of the SARS-CoV-2 virus, or any mandatory or advisory restriction issued, or action ordered or threatened, by any applicable government authority in connection therewith, including the failure to comply with laws in connection therewith
- the application for, acceptance of, use of or repayment of **any tax credits, loans, grants, funds or other program** established or expanded, by a Governmental Entity in connection with, or in response to, COVID-19
- **any disruptions to the ordinary course operations** of the Company's business, including a reduction in revenue or increase in expenses, difficulty in personnel recruiting, or loss of key personnel to the extent such events are the direct result of the spread of the COVID-19 virus
- resulting from or to the extent Losses are increased by, **disruptions or other adverse effects to the Company's supply chain or operations** that are attributable in whole or in part to COVID-19 disease or the SARS-CoV-2 virus, or any evolution thereof

Narrowing COVID-19 R&W Exclusions

- arises or results from the **failure to protect** any employee, contractor, worker, officer, director, manager, agent, customer, client, supplier, distributor, vendor or any other person from contracting, or the **transmission** of, Covid-19
- arises or results from a breach of a representation **made at Closing** arising or resulting from (i) any **actual and material** business interruption to the extent such interruption directly relates to the **actual** presence, transmission or spread of Covid-19, or (ii) any mandatory action or order of any applicable governmental or regulatory authority undertaken in connection with the actual presence, transmission or spread of
- “any **sickness, bodily injury or bodily harm** due to failure to protect any employee, contractor, officer, director, manager, agent, customer, client, supplier, distributor or any other person from the transmission of COVID-19

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R&W Claims

AIG Claims Intelligence Series – Representations and Warranties Insurance United States Claims Study 2020 available at

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

Fig 2 R&W Reported Claim Frequency by Deal Size
(numbers may not add up due to rounding)

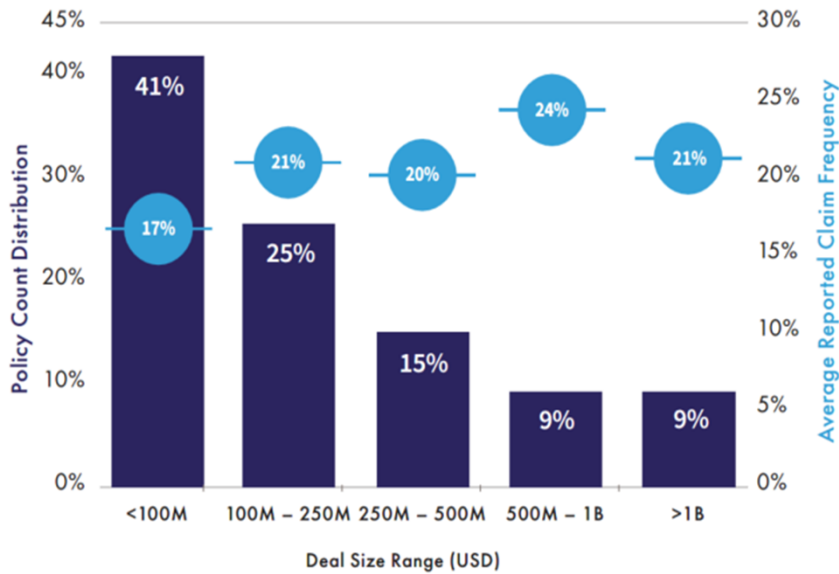
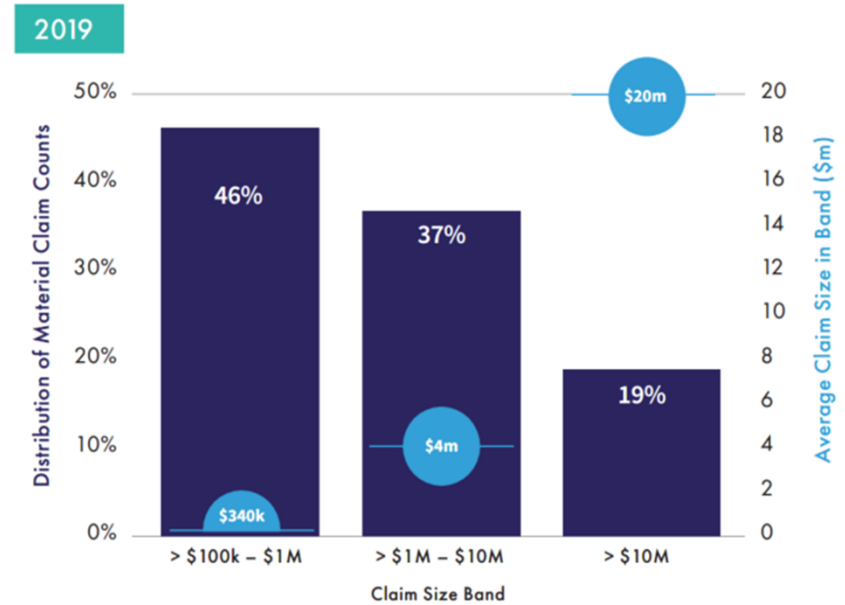


Fig 1 R&W Material Claims – Distribution of Counts and Average Size by Claim Size Band

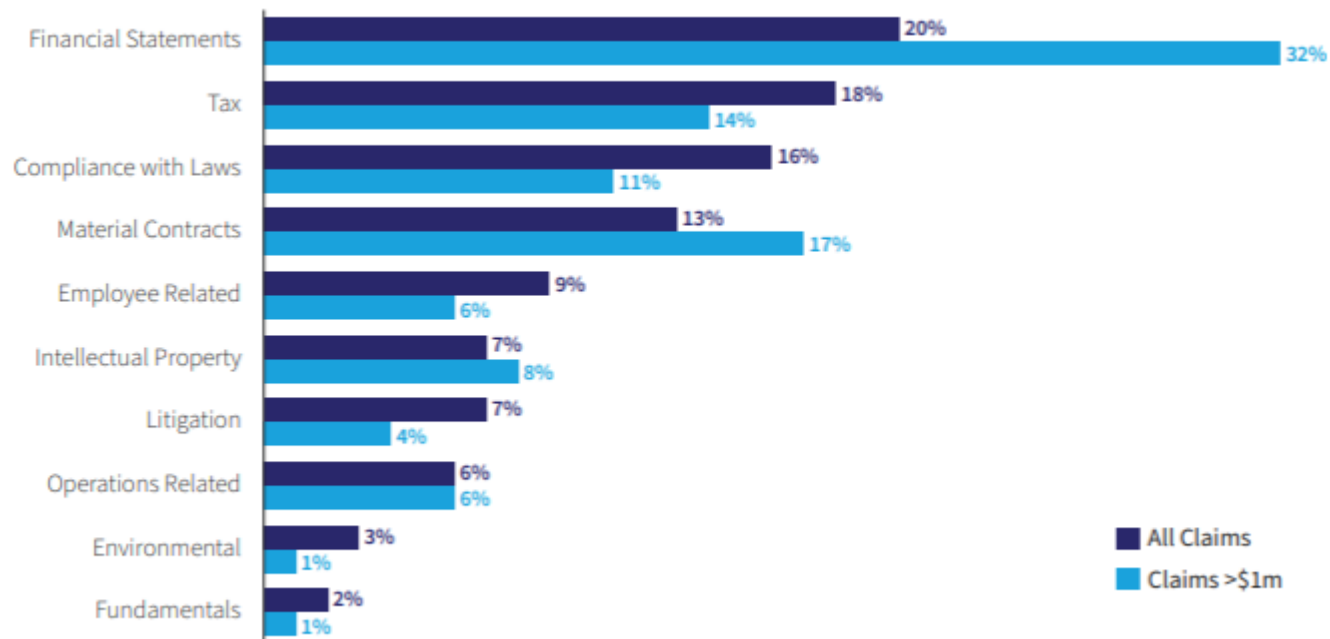


R&W Claims

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

Fig 5 R&W reported incidents by breach type All Claims vs Claims >\$1m



Claim Resolution

AON Representations and Warranties Insurance Claims Study
 available at <https://www.aon.com/risk-services/amats/2019rwclaims>

Figure 7. Percentage of Claim Payouts Above the Policy Retention That Fall within Each Payment Band

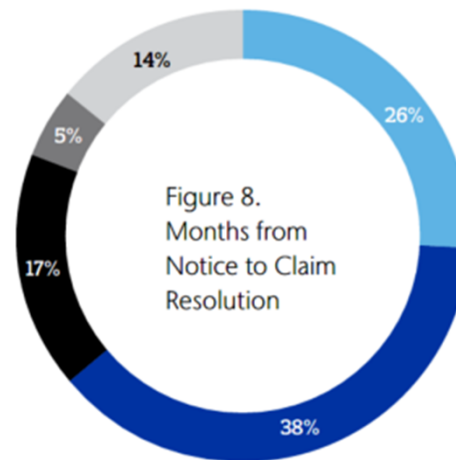
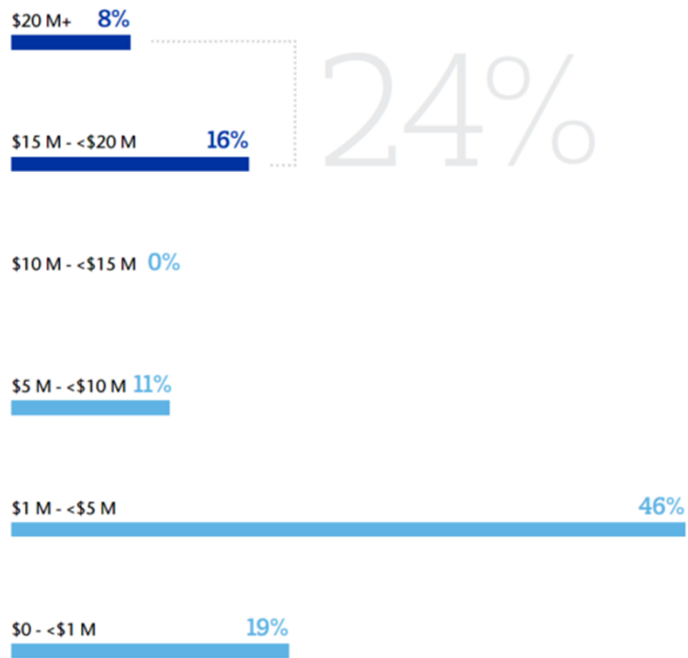


Figure 8.
 Months from
 Notice to Claim
 Resolution

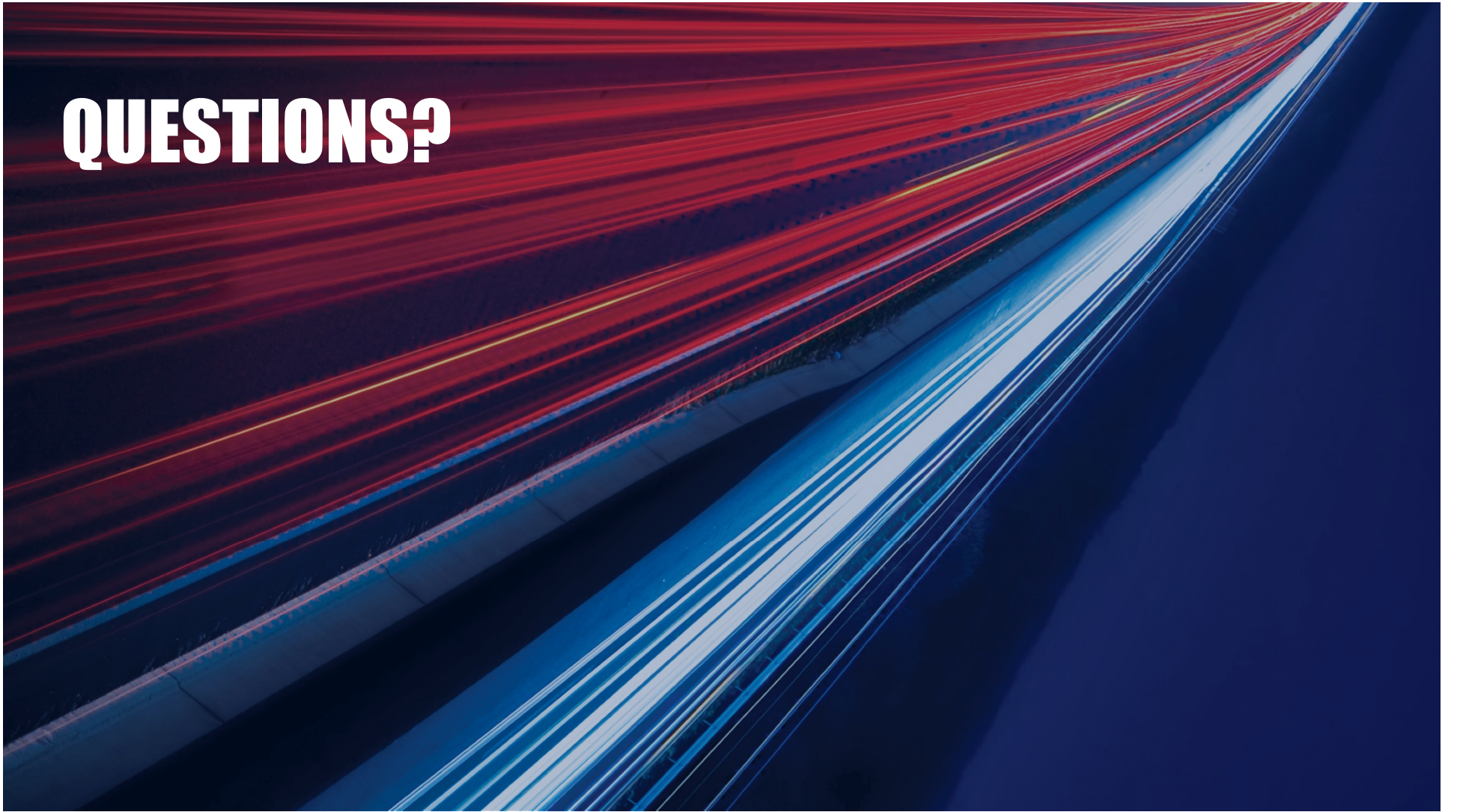
- < 6 Months
- 6-12 Months
- 12-18 Months
- 18-24 Months
- > 24 Months

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Key Takeaways from This Session

- R&W Insurance is an integral part of the M&A market and the volume of insured transactions has not been affected disproportionately to general M&A activity.
- Insurers are particularly focused on the effect of the pandemic on the target's business in the diligence stage and on changes during the bring-down period.
- Insurers are not using uniform exclusionary language for COVID-19, but exclusions have gotten more negotiable and the language is more tailored.
- There is still resistance to underwriting representations regarding PPP Loan matters.
- The impact of COVID-19 on claims activity remains to be seen.

QUESTIONS?



Biography



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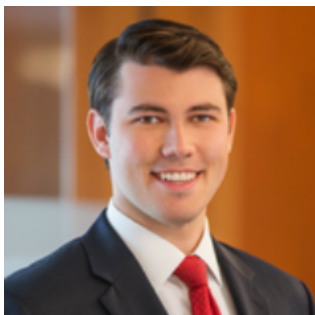
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Ariane Baczynski focuses her practice on complex commercial disputes. She represents corporate policyholders in insurance coverage disputes involving matters such as management, product, and environmental liability claims.

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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Spencer Curtis represents global securities issuers, investment funds, and strategic buyers and sellers across industries in connection with mergers and acquisitions (M&A), investments, divestitures, private equity and debt financings, and general corporate and governance matters.

Spencer has a focus on insurance and financial services industry transactions and represents representation and warranty insurance providers in support of their transaction risk underwriting processes.

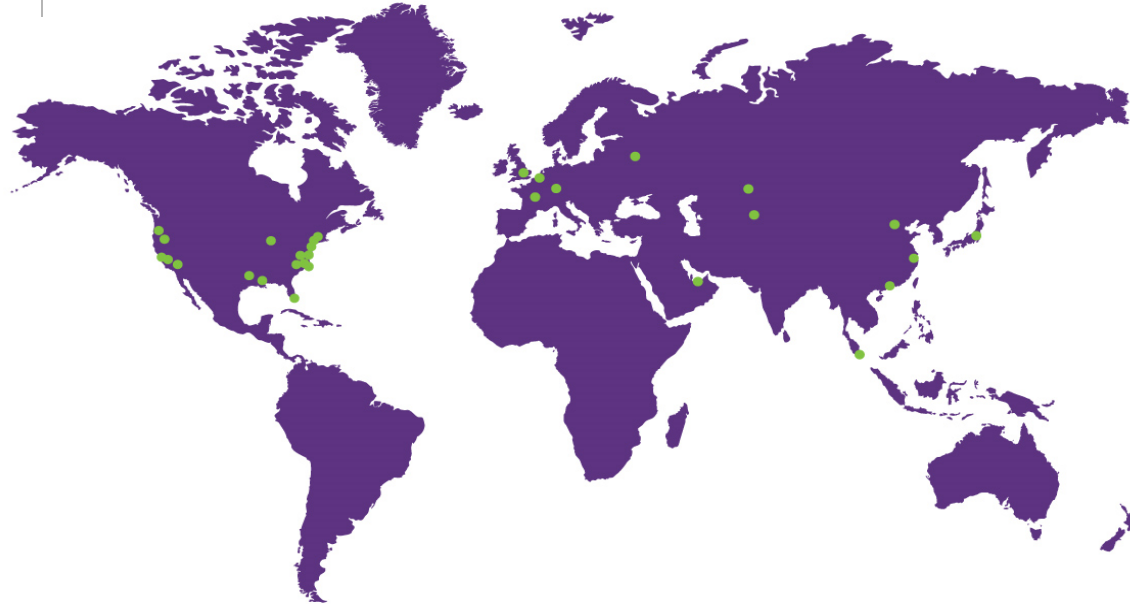
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