

Nuts & Bolts of Representations and Warranties Insurance

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Representations and warranties insurance (“RWI”) is highly customized insurance for an M&A transaction’s risk allocation provisions. When negotiating a purchase agreement, a purchaser typically will seek contractual assurances, backed by an escrow or a holdback, regarding the business being purchased. However, this negotiated risk allocation can be impractical in certain situations, such as when a private equity seller is nearing the end of its fund life and needs to be able to return funds to its investors, or an ESOP is a significant owner of the seller.

This client alert provides a brief primer on the structure, coverage, exclusions, retention and costs of typical RWI policies, and elaborates on various considerations for sellers and purchasers in using RWI policies as part of the risk allocation in M&A transactions.

When to Use an RWI Policy

In negotiating the indemnification and related escrow or holdback provisions of a purchase agreement, the purchaser is concerned about receiving the benefit of its bargain and not bearing the risk of undisclosed liabilities and costs relating to the acquired business. The seller typically wants to maximize the closing proceeds and minimize the amount of the purchase price placed at risk. An RWI policy can help address those concerns, and can be put in place without delaying a transaction. RWI is also useful in situations where indemnification is unavailable, impractical or uncertain, e.g. purchasing assets out of bankruptcy or purchasing a business from a distressed seller, from a private equity seller winding down its fund, from a public company, from an ESOP, or from numerous sellers wanting to avoid joint and several liability. If selling owners are continuing on as management of the acquired business, RWI can relieve the purchaser’s concerns about having to pursue indemnification from management. In a competitive bid process, a seller might require the use of RWI or a purchaser could use RWI to distinguish its bid by reducing or even eliminating the need for a seller indemnity. Payment of the premium for

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an RWI policy is often negotiated or reflected in the purchase price. Both parties typically benefit, so the premiums may be split.

Insured Party

RWI may specify either the seller (seller-side policy) or the purchaser (buyer-side policy) as the insured. Buyer-side policies are more prevalent, perhaps because they are generally viewed as providing greater protection. The policy may be procured by either the purchaser or the seller, depending on the situation, regardless of who is the insured. A seller or purchaser could procure an RWI policy under which they are the insured without the other party necessarily knowing about it.

Structure of the RWI Policy

An RWI policy often serves as a backstop (seller-side) or security (buyer-side) for a seller's indemnification obligations for breaches of representations and warranties under the purchase agreement. Under this structure, while the seller is contractually obligated to indemnify the purchaser for the breaches, the RWI policy will provide coverage for claims made for breaches in excess of the policy retention. The seller may want to provide in the purchase agreement that a buyer-side policy is the first recourse for the purchaser for such indemnity claims.

Alternatively, the RWI policy could partially replace (by layering in coverage over the seller's indemnity cap) or completely replace the seller's indemnity obligation. Under partial replacement structure, the seller would be liable to the purchaser up to its indemnity cap and the purchaser would proceed against the policy for any amount above the seller's indemnity cap. In a complete replacement, the policy would be the sole recourse for the purchaser for indemnity claims resulting from a breach of the seller's representations and warranties. Insurers generally prefer underwriting RWI in a transaction in which the seller retains some of the liability for breaches of its representations and warranties. However, as the RWI market has evolved, underwriters are more willing to insure transactions where the RWI policy is the sole recourse available to the purchaser for payment of its indemnity claims.

Claims handling procedures differ under buyer-side and seller-side policies. Seller-side policies are third party liability policies. If the purchaser makes a claim against the seller for breach of the purchase agreement representations and warranties, the seller submits the claim to its insurer, but the seller remains liable to the purchaser under the purchase agreement (up to any applicable indemnity cap). Buyer-side policies provide first party loss coverage. Upon discovering the breach of a representation and warranty following closing, the purchaser makes its claim directly to the insurer under the policy.

Scope of Coverage and Exclusions

An RWI policy provides coverage to the insured for financial loss (including defense costs) resulting from a breach of the representations and warranties in a purchase agreement. The seller's indemnity obligations under a typical purchase agreement, however, often extend beyond breaches of representations and warranties. A typical indemnity provision might obligate a seller to also indemnify the purchaser for breaches of covenants and for specific liabilities such as outstanding litigation or other known potential risks disclosed or discovered during due diligence (e.g. environmental, tax, or benefit plan liabilities). A typical RWI policy will exclude these other matters from the scope of coverage. The purchaser might either continue to look to the seller for indemnification in respect of these other matters or purchase a specific transaction liability product covering the specific liabilities.

Some insurers will cover all representations and warranties while other insurers may exclude certain representations and warranties such as environmental. An insurer may also exclude (or modify, for purposes of the policy) certain representations and warranties that it views as unduly purchaser-friendly or too easily breached (e.g. missing usual qualifiers). The insurer would typically raise such matters during underwriting due diligence and then the parties can decide how to address the issue.

Common exclusions under RWI policies include fraud (although buyer-side policies will cover seller's fraud), disclosed items or otherwise actually known breaches, fines and penalties, purchase price adjustments, and forward-looking statements. Policies also exclude injunctive, equitable and other non-monetary relief. An insured may be able to negotiate coverage for diminution of value or a multiple-based calculation of damages for a breach of a representation and warranty, or at least silence on the type of damages that can be recovered under the policy. Anecdotally, in appropriate circumstances, insurers have paid out on claims for such damages. Insurers will typically agree that subrogation against the seller is limited to fraud, and to severability among sellers as relates to knowledge.

RWI policies are written on a claims-made basis, with coverage triggered only by a loss or claim occurring within the defined policy period. The policy typically takes effect at closing of a transaction (which could create a coverage gap if the purchase agreement is signed before closing). Although the policy period is often matched to the survival periods under the purchase agreement, RWI policies also can be issued for longer than the seller's survival periods to cover claims for breaches that become apparent only after those periods have ended.

Significant negotiation and care may be required to fit an RWI policy to a particular transaction and ensure that the policy provides the desired coverage. The coverage amount, policy period, premium, retention, loss definition, and exclusions must be negotiated with the insurer. Although coverage can be bound quickly, the insured usually can secure better terms if it allows at least 2-3 weeks for underwriting due diligence and negotiation of the policy.

Although dealing with an insurer poses potential credit and coverage risks, established RWI insurers often are AAA rated (which may make them more financially viable than a seller)

and they have an incentive to act reasonably when responding to a claim in a competitive insurance market.

Retention

RWI policies usually require a retention to be satisfied before the insurer is obligated to cover claims. For most policies, the retention ranges from 1% to 3% of the transaction purchase price. If the transaction involves an escrow, the escrow would typically serve as the retention, with any losses going first to exhaust the escrow before the insurer's obligation to cover losses kicks in. RWI policies typically provide that uncovered matters do not erode the retention, although the insurer may agree to certain exceptions. Lower retentions may be available at higher premiums, and an insured may be able to negotiate step-downs in the retention over time if no losses have occurred.

Costs

Premiums for RWI policies typically range from 2% to 4% of the coverage limits purchased. Factors that can affect premiums include the insurer's assessment of the quality of the due diligence and reps/warranties, the retention amount, the coverage limit, and the policy period. Premiums are typically slightly higher for buyer-side policies than seller-side policies (seller fraud is covered and purchasers are generally presumed to have less knowledge than sellers with respect to breaches). The RWI premium typically covers the brokerage commission, but not any applicable state surplus line or premium taxes. Insurers also charge an underwriting fee (typically \$15,000 to \$50,000) for due diligence and other legal costs.

Coverage limits depend on the insurer, but often range from a minimum of \$10 million to \$300 million or more. Primary and excess layers are stacked for the higher coverage limits.

Conclusion

RWI can be an effective tool as a backstop, supplement or replacement for the seller's indemnification obligations under a purchase agreement, and can be customized to fit the parties' needs in a particular transaction. The RWI market has continued to evolve and has gained significant traction in the last few years, mainly due to lower premiums and improved terms of coverage. Sellers have used RWI to maximize closing proceeds and exit cleanly. Purchasers have used RWI to obtain additional protection beyond the indemnity cap and survival limitations negotiated with the seller and improve their bid in auctions. The terms of an RWI policy must be negotiated to fit the particular transaction and ensure that the policy provides the desired coverage.

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