

A Primer on Representations and Warranties Insurance

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Introduction

The allocation of risk shapes every acquisition, and the backbone of risk allocation is the right of the acquiring company, the buyer, to be indemnified for breaches of the seller's representations and warranties. For M&A deals involving the acquisition of a private target entity, the sellers typically bear the indemnification risk. This risk has traditionally been managed using a two-tiered structure: (i) a holdback or escrow funded from proceeds the sellers ultimately expect to receive, and (ii) in the event of a claim beyond the holdback or escrow, the right of the buyer to clawback proceeds from the sellers directly. In the late 1990s/early 2000s, RWI emerged as a niche tool to shift some or all indemnification risk to an insurer. Due to falling costs, quicker and more efficient underwriting and improving policy terms, RWI is rising in popularity in recent years. However, in the U.S., it remains a specialized product that many M&A professionals are still learning about.

An RWI policy can be either "buy-side" or "sell-side." When the buyer is the insured (a buy-side RWI policy), RWI can reduce or eliminate the need for a holdback or escrow because the buyer can pursue the insurance policy instead of pursuing the sellers; although, it should be noted that the sellers may remain liable for purchase price adjustments and other excluded matters as well as for liability above the insurance limits and for fraud. When the sellers are the insured (a sell-side RWI policy), they remain liable to the buyer pursuant to the underlying acquisition agreement, but the insurance policy serves to protect the sellers against covered losses when the buyer seeks indemnification from them with respect to breaches of their representations and warranties.

In the U.S. market, buy-side RWI is more prevalent than sell-side RWI, comprising a large majority of the RWI policies issued according to major insurers and available market data.

Why Buyers and Sellers Use RWI

A. Buy-Side RWI

Buy-side RWI policies allow the buyer to seek indemnification from an insurer for losses covered by the policy. Buy-side RWI is often used to:

1. Enhance the buyer's bid for a desirable target entity. In a competitive auction scenario, for example, the buyer's willingness to recover from a buy-side RWI policy instead of from a traditional holdback or escrow can make the buyer's bid more competitive.
2. Protect deal relationships. Where a buyer desires to protect seller or target-company management relationships post-closing (such as with respect to key employees or investors), buy-side RWI alleviates the likelihood of needing to proceed against the sellers in the event of a breach of their representations and warranties.
3. Maximize sellers' internal rate of return (IRR). Buy-side RWI that reduces or replaces the need for traditional holdbacks or escrows allows the sellers to receive proportionally more proceeds at closing, which may enable institutional sellers to make proportionately larger distributions to investors at closing.
4. Bridge the gap in indemnification terms. Buy-side RWI can be used to supplement the sellers' indemnification obligations, if the buyer desires greater protection than that provided by the underlying acquisition agreement's indemnification provisions.
5. Facilitate acquisition lending. Insurance proceeds paid out under a buy-side RWI policy are assignable to acquisition lenders. This may be an important factor for lenders, especially in highly leveraged transactions.

B. Sell-Side RWI

Sell-side RWI policies protect the sellers against covered losses when the buyer seeks indemnification from them with respect to breaches of their representations and warranties and can be designed to protect all or part of the held-back or escrowed funds or to protect sellers' clawback risk above such funds, or a combination of all of the preceding. Sell-side RWI is often used to:

1. Add certainty to the purchase price. Sell-side RWI compensates sellers for indemnification-related covered losses, providing a greater sense of certainty with respect to the purchase price.
2. Maximize IRR. Sell-side RWI may alleviate the need for sellers to set aside internal reserves for contingent liabilities, which may allow for earlier distribution of closing proceeds to sell-side parties.
3. Close quickly. With sell-side RWI backstopping their risk, sellers may be willing to negotiate and close the underlying M&A deal quickly, even when the buyer insists on a holdback or escrow.
4. Protect passive and minority sellers. Sell-side RWI can protect all sellers' indemnification risk, including passive and minority sellers who may not have been involved with the day-to-day operations of the target entity or the deal-specific negotiation of the representations and warranties and indemnification provisions.

What steps are typically involved in the RWI process, and how does the process differ for buy-side RWI policies as opposed to sell-side RWI policies?

A. Three-Step Process

Purchasing RWI coverage typically proceeds in three stages and involves the proposed insured, an insurance agency and one or more insurance underwriters. The overall process may take two to three weeks, including several business days for the underwriters to review submission materials and issue non-binding indication letters (also known as quote letters) and approximately 1 to 2 weeks for the formal underwriting process, underwriting call and policy wording negotiation. Quicker turnaround is sometimes feasible, and factors that affect timing include things such as seasonality, transaction-complexity, level of detail discussed on the underwriting call, timing of responses to the underwriter's follow-up questions after the call and use of previously used policy wording.

STEP 1: Submit Underwriting Materials and Solicit Quotes

The proposed insured and its insurance agent discuss the underlying M&A deal and the structure of the desired RWI coverage, and the insurance agent submits preliminary underwriting materials to one or more RWI underwriters. Preliminary submission materials typically include the target company's financial statements and a current draft of the acquisition agreement, and, if available, draft disclosure schedules and target company overview materials (e.g., Pitch Book, Confidential Informational Memo, Board Presentation, Lender Presentation).

STEP 2: Receive and Review Quotes and Negotiate Any Desired Changes

During this stage, the insurance underwriters review the preliminary submission materials and, if interested in the RWI opportunity, provide non-binding indication letters (also known as quote letters) showing preliminary insurance terms. The insurance agent typically reviews the quotes with the proposed insured and, if applicable, assists with the RWI preliminary negotiations.

STEP 3: Underwrite and Bind Coverage

Most RWI underwriters charge an underwriting fee to cover the expected costs of their outside underwriting counsel, with the fee typically due when the proposed insured focuses in on one quote and selects the corresponding insurance carrier to initiate formal underwriting. Underwriting counsel typically assists the insurance underwriters with the review of the acquisition agreement and disclosure schedules and the data room and due diligence memoranda. The insurer and their counsel then conduct an underwriting call with the proposed insured, their deal advisors (e.g., legal, financial, tax) and their insurance agent. Once any underwriting call follow-up questions are answered and policy wording is negotiated, RWI coverage is typically bound at signing or closing. RWI coverage can also be bound post-closing, but it should be noted that finalizing RWI coverage after the underlying M&A deal is signed or closed results in the proposed insured being uninsured against reps and warranties breaches during that interim time period.

B. Buy-Side and Sell-Side RWI Underwriting

With both buy-side and sell-side RWI coverage, the underwriting process is intended to provide the insurer and their counsel with comfort regarding the people and process involved in the underlying M&A deal; although, the insurance underwriters may speak with different people for each type of coverage and may have access to different written materials. For example, during buy-side RWI underwriting, the insurer and its underwriting counsel typically evaluate the thoroughness of the buyer's due diligence by speaking with the buyer and their advisors and examining the buyer's due-diligence-efforts request list and internal or external diligence reports. During sell-side underwriting, the insurer and their underwriting counsel typically evaluate the sellers' due-diligence-response efforts and disclosure process by speaking with the target company management, the sellers and their advisors and examining the buyer's due-diligence-request list, but there typically is not access to the buyer's diligence reports. The insurer and their underwriting counsel will generally require access to the data room regardless of whether underwriting a buy-side or sell-side RWI policy, as spot-checking the data room information against the sellers' disclosure schedules can help the insurer and underwriting counsel ascertain the thoroughness and accuracy of those schedules.

What are typical RWI policy terms and exclusions?

A. Typical Terms

Each policy is tailored to the transaction. Typical terms include:

1. **Pricing.** The premium is a percentage of the insured amount, typically 2.5 to 6%. Relevant factors affecting pricing include things such as transaction value, deductible size, target company industry and business line, scope and depth of indemnification obligations, amount of time between signing and closing, quality of the transaction diligence, identity of transaction principals and their advisors and insurance market dynamics. In addition to the insurance premium, most RWI underwriters charge an underwriting fee to cover the expected costs of their outside underwriting counsel, with the fee typically due when the proposed insured focuses in on one quote and selects the corresponding insurance carrier to initiate formal underwriting.
2. **Deductible.** The deal parties bear a portion of the risk in the form of a deductible (also known as a retention) before a claim can be made under the RWI policy. Deductibles for RWI policies are often in the range of 1 to 2% of the underlying M&A deal value; although, higher deductibles may apply for smaller transactions. With sell-side RWI coverage, the sellers sometimes request the deductible to equal the indemnification escrow, with the RWI coverage applying that attachment point to protect against clawback risk above the escrow.
3. **Coverage.** RWI policies generally cover unexpected, unknown breaches of the representations and warranties made by the sellers in the acquisition agreement, subject to exclusions for high-risk areas or risks that the insurer is

- not willing to cover. Exclusions are discussed in the next section.
4. **Duration.** While RWI policy coverage periods can be set to match the underlying acquisition agreement's survival and indemnification periods, it's more common to see a 3/6 split, meaning a three-year policy period applicable to discoveries of breaches of general reps and warranties and a six-year (or shorter statute of limitations) policy period applicable to discoveries of breaches of tax and fundamental reps and warranties. Certain reps and warranties not typically defined as "fundamental" are sometimes eligible for the longer policy period.
 5. **"No-claims" declaration.** RWI underwriters generally require a no-claims declaration from the insured at the time of binding the RWI coverage stating that the deal team members are not aware of any existing or expected breaches of the covered representations and warranties. While exact scope and wording vary, the intent is to reinforce that RWI coverage is not generally intended to cover known or expected breaches.
 6. **Subrogation.** RWI insurers typically retain the right to subrogate against (i.e., seek recourse against) responsible parties that caused the insured loss. While subrogation is not an unusual concept in the insurance industry, it is sometimes negotiated case by case with respect to RWI coverage. For example, buy-side RWI policies sometimes limit the insurers right to subrogate against the sellers to situations involving sell-side fraud in the underlying M&A deal.

B. Typical Exclusions

While each RWI policy is unique and tailored to address the underlying M&A deal, RWI policies typically do not cover purchase price adjustments, breaches of covenants or forward-looking statements or underfunding of employee benefit plans. Deal-specific exclusions are sometimes included in RWI policies for known or expected breaches or other matters that are known problems or that were not diligenced sufficiently, and sell-side RWI policies typically include a fraud exclusion. Specific escrows or other transactional insurance products such as tax insurance, specific litigation insurance and contingent liability insurance may be available to address some of the risks not typically covered by RWI policies.

How are claims under the policy handled?

Typically, the insured is required to notify the insurer of breaches or potential financial losses that may erode the deductible or cause a claim against the RWI policy. Further, the insurer often has participation and consent rights with respect to litigating and settling claims brought against the insured by third parties. Once an insurable loss materializes, the insured can make a claim under the policy. The insurer will review the claim to determine whether the loss is covered and to what extent. If the loss is covered, the insurer will typically reimburse the insured for a loss incurred or, if the loss is owed to a third party, pay such third party on behalf of the insured. The RWI broker's role during the claims process is to assist the insured in negotiating with the insurer to facilitate a claim payout.

As noted above, each RWI policy is unique and tailored to the specific underlying M&A

deal, but it's common for RWI policies to require the insured to inform the RWI insurer of breaches that erode the deductible and breaches that are expected to result in loss payments under the RWI policy, and some RWI policies also required notice of facts or circumstances that may result in such breaches. Once a claim is made against an RWI policy, the RWI insurer will typically review the claim to determine whether a covered breach occurred, whether any such breach resulted in covered loss and the amount of any such loss. To some extent, the insurer's claim review process can be thought of as similar to the process that sellers or a sell-side representative or advisor would perform with respect to indemnification claims received from a buyer in a deal with no RWI.

What are the benefits and drawbacks of escrows versus RWI?

Escrows and RWI are alternative means of collateralizing sellers' indemnification obligations. The primary benefits and drawbacks of using escrows versus using RWI are summarized below.

A. Escrows

Benefits

1. Guaranteed source of indemnification collateral for the buyer.
2. Fast and easy to set up, with little or no out-of-pocket cost.
3. No need for underwriting or the involvement of a third-party insurer in deal negotiations.
4. The buyer and sellers negotiate directly (or through a seller representative or advisor) when claims arise.

Drawbacks

1. The sellers' proceeds used to fund the escrow are at risk of indemnification claims.
2. The sellers lose the use of escrowed proceeds during the escrow period.
3. Escrow deposits generally earn a lower yield than what an institutional investor may expect to earn by investing such capital pursuant to an investment strategy.

B. RWI

Benefits

1. A buyer willing to use buy-side RWI in lieu of a standard holdback or escrow arrangement can enhance their bid since the sellers will receive a greater proportion of the purchase price at closing and will have lower indemnification risk.
2. Using insurance proceeds to fund indemnification claim payments may protect relationships between buy-side parties during the deal negotiation stage and post-closing.
3. Enhances sellers' IRR where RWI negates the need for an escrow (in buy-side RWI policies) or for contingency reserves (in sell-side RWI policies above the escrow), maximizing sellers' distributable proceeds at

closing.

4. Adds additional certainty to the purchase price received by sellers.
5. Allows sellers to exit with less risk of a clawback (in sell-side RWI policies above the escrow).
6. Reduces credit risk borne by the buyer for coverage that applies above the holdback or escrow.

Drawbacks

1. The insurance premium is an additional cost.
2. The insurance underwriting process may add complexity and time.
3. The RWI policy may have material exclusions, but specific holdbacks or escrows, or a separate insurance policy, may alleviate this concern.
4. Claims must be negotiated with the insurer.
5. A series of material claims by a buyer against an RWI policy may impact that buyer's future RWI pricing (i.e., the buyer's perceived risk profile), but even a buyer that pursues multiple indemnification claims against sellers directly may find themselves labeled litigious or overly aggressive in the M&A community.
6. Buyers tend to be more aggressive in making claims against an RWI policy as opposed to the sellers directly, potentially eating into coverage amounts more quickly.

Conclusion

RWI is a tool to potentially allocate risk and increase the amount payable to sellers at the time of closing, and it may even be the key to winning a competitive bid. Whether RWI or an escrow is the right tool for your M&A deal ultimately depends on the circumstances. In making this decision, it is critical to engage a neutral, experienced advisor you can trust since the optimal tool may change as the M&A deal evolves and since the best tool for one M&A deal may not be the best tool for another M&A deal.

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Kip is a senior director leading the SRS Acquiom thought leadership practice, the mission of which is to share resourceful content built from SRS Acquiom expertise and proprietary data. In addition to facilitating scores of interactive presentations at M&A conferences and law firms, Kip authors a plethora of articles and data studies regularly utilized by the market.

Previously, Kip was a part of the SRS Acquiom Transactional Group, where he collaborated with clients and counsel to negotiate M&A documents including purchase, escrow, payments, and other transactional agreements. Before joining SRS Acquiom, he was an attorney with a Denver-based boutique business law firm working on middle-market M&A deals.

Kip holds J.D. and M.S. (econometrics) degrees and is a member of the Colorado bar.