

# REPRESENTATIONS AND WARRANTIES INSURANCE (RWI) SOLUTIONS FOR MUSIC RIGHTS PORTFOLIO DEALS

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RWI has long been a staple in private transactions, but its application to music rights portfolio deals is a more recent development. With at least a dozen such deals now insured, the number is expected to rise as market consolidation continues, and buyers are increasingly leveraging RWI to secure competitive advantages in auctions and streamline negotiations with sellers. This note draws on Atlantic's experience in insuring some of the most complex music rights transactions and outlines best practices for maximizing coverage under RWI policies.

## Industry Specific Diligence Approach

Atlantic's legal, financial, tax and insurance specialists assist in scoping the due diligence exercise at the outset of a music rights portfolio deal to ensure that the diligence conducted allows for fulsome cover to be secured. The key items to consider from a diligence perspective and to pre-negotiate with insurers prior to the selection of a primary insurer are:

### 1. Sampling Exercise:

Depending on how fragmented the music rights portfolio is, some insurers can provide cover for all intellectual property rights ("IP") and contracts in the portfolio based on a sampling exercise that diligences only the most material IP and contracts (e.g., those contributing to the top ~60% of net revenue). This approach can save the buyer time and cost and avoids the need to diligence a long-tail of lower-value IP and contracts.

### 2. Rights-In and Rights-Out Analysis:

A standard diligence review of the material contracts that underpin the music rights portfolio (i.e., review of key provisions, flagging of unfavorable terms and confirmation from the sellers regarding any breaches or terminations) is, subject to reasonable findings, enough to obtain broad cover for the material contracts representations. For purposes of diligence, those material contracts can be split into the following two buckets:

- The "rights-in" contracts that give the target the rights to the music in the portfolio, including the acquisition agreements, co-publishing agreements, administrative agreements and joint venture agreements that were entered into by the target as it built out its portfolio.
- The "rights-out" contracts that enable the target to monetize the rights that it owns under the rights-in contracts, including distribution agreements, digital distribution agreements and sub-publishing agreements.

The sampling exercise described in no.1 above can be applied if the music rights portfolio is highly fragmented, with the use of form/template documents throughout the portfolio a helpful fact pattern.

### **3. Chain of Title Analysis:**

A chain of title analysis (i.e., a review of relevant statutory termination issues and copyright reports which outline the sequence of ownership of the relevant IP up until closing) is required to support the rights-in and rights-out analysis described above. Subject to the chain of title analysis verifying/being consistent with the outcome of the rights-in and rights-out analysis, this exercise will be sufficient to obtain broad cover for the IP title reps. Again, a sampling approach to chain of title analysis is possible for fragmented music rights portfolios.

### **4. Non-Infringement of IP:**

Subject to the nature of the underlying IP (i.e., composition copyright versus sound recording copyright) and the popularity of the portfolio, certain insurers are willing to cover non-infringement of third party IP by the target and third party infringement of the target's IP based on just IP and litigation searches (i.e., capital and time intensive freedom to operate analyses are not required). It may however be challenging to get an insurer comfortable if a material artist/catalogue in the portfolio uses samples or derivative works (e.g., remixes, mashups, use of artificial intelligence to copy voices or style of others).

### **5. Unregistered Copyrights:**

Insurers have historically excluded any unregistered copyrights from cover given they are difficult to fulsomely diligence. Atlantic, however, recently negotiated for cover of unregistered copyrights that were material to the target portfolio, subject to a review of internal copyright policies/procedures, interviews with the creators of the creative assets and online searches to identify potential infringement. Any known exposures discovered as part of this diligence were excluded from the RWI policy.

### **6. Financial Statements:**

A buy-side quality of earnings analysis is required for insurers to cover financial statements representations. For music rights portfolio deals, insurers want to see an assessment of specific contracted revenue streams, and some are now comfortable if this analysis is conducted internally if the buyer employs appropriately qualified individuals.

Given how fragmented the revenue generating IP and contracts in a portfolio may be, and the number of intermediaries that may be involved, only a handful of insurers are currently comfortable underwriting and providing cover for representations which speak to (i) net publisher share/net label share, (ii) material debts, liabilities or creditors, and (iii) unrecouped advances.

Obtaining cover for representations which speak to royalty audits will likely require the buyer and its advisors to speak to the target's audit rights and history of exercising such rights in detail during the underwriting call. As is the case with other insured deals, known issues regarding non-payment by or of third parties will likely be excluded from cover by the RWI insurer.

### **7. Asset Sale vs. Share Sale:**

If a music rights portfolio deal is structured as an asset sale as opposed to a share sale, the scope of diligence the buyer will need to conduct in order to obtain fulsome cover will be reduced, e.g., insurers will not expect significant tax diligence.

## Premiums, Retentions and Policy Enhancements

Outside of the industry specific diligence approach that is described above, music rights portfolio deals are currently priced at the same levels and have the same policy enhancements available to them as typical private transactions do.

- For transactions with deal values of \$51m – \$1b, buyers typically purchase policy limits of 10 – 30% of the enterprise value ("EV"), with current premium rates for a 10% limit being ~2.5 – 3.0% of the limit purchased (the "rate on line" or "ROL"), significantly less than historic averages of ~3.5 – 4% ROL.
- Rates for larger transactions or those with limits of 20 – 30% of deal value are even lower, often less than 2% ROL.
- Insurers' minimum premium requirements mean that minimum all-in costs for a RWI policy are now between \$175,000 and \$200,000. This means that transactions with deal values well below \$50m are insurable and that buyers in these smaller transactions typically purchase policy limits of above 20% of the purchase price to make the RWI policy cost effective.
- Initial retentions are now typically ~0.5% of the EV and drop to 0.3% of the EV 12 months after closing. For large or particularly desirable transactions, the retention can be even lower.
- Representations which speak to the title and non-infringement of IP can be covered for six years instead of the typical three years, sometimes without additional premium being charged. It is also possible to secure "top up" cover up to 100% of the portfolio value for these representations for rates of between 1% and 1.5% of the amount of limit purchased.
- Defense and prosecution costs related to third-party IP disputes have led to full limit losses under RWI policies, and while the insured was able to recover their losses up to the policy limit, in many cases they only purchased a 10% limit and were ultimately under-insured. In the past, such defense and prosecution costs have led to full limit recoveries by buyers of IP-heavy targets.

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