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EMERGING RISK

REPRESENTATIONS & WARRANTIES INSURANCE

A practical analysis

As the name suggests, representations and warranties (R&W) insurance provides financial cover to the insured in the event of a breach of a representation or warranty.

The R&W policy can be held by either the seller or the purchaser. However, it is much more common for R&W insurance to be placed on the buy-side. The advantage of insuring the purchaser (rather than the seller) is that it allows a direct claim to be made against the insurer, avoiding the need to pursue the seller.

Buy-side policies help facilitate deals by transferring risk that is otherwise allocated between the parties (often via fraught negotiations), to the insurance market. Buy-side R&W insurance provides a purchaser with an A-rated counterparty to recover from up to the required indemnity cap, whilst at the same time ensuring a clean exit for the seller.

In recent years, the M&A market has continued to shift in favor of sellers. This has resulted in purchasers being unable to secure a sufficient level of indemnity protection for a breach of representation or warranty under a purchase agreement. In addition, we have seen a growing number of secondary buy-outs, where private equity sellers are reluctant to take on liabilities from representations (as it limits distribution to investors). The combination of these two factors has created the perfect environment in which R&W insurance has flourished and grown as a key method to bridge the gap between what the seller is willing to offer and what the purchaser expects. As awareness of the product continues to grow, it seems inevitable that R&W insurance will remain a key feature of the deal landscape.

Why is R&W insurance gaining traction?

For a private equity seller, providing representations on the sale of a portfolio company has always come with a cost. Even if the seller avoids a purchaser's demand to place a portion of sale proceeds into an escrow account (often the selling entity's assets will be limited to the shares of the company it is selling), the contingent liabilities will restrict the distribution of proceeds to investors. This creates a drag on IRR by increasing the time period over which returns are delivered to investors.

Both corporates and private equity funds have record levels of capital at their disposal – the latter driven by successful fund raising aided by institutional investors' increased allocation to private equity as an asset class. This record level of capital has resulted in high levels of demand for companies being sold through auction processes, which in turn, has led to sellers enjoying significant leverage over bidders. Increased leverage has allowed them to dictate auction processes and many private equity sellers have used this leverage and the increased availability of R&W insurance to cap liability on exit. Instead of looking to the seller for indemnity protection under the purchase agreement, sellers are inviting bidders to secure protection through R&W insurance.

Sellers will cap liability under the purchase agreement to a low level (frequently NIL) with purchasers obtaining the indemnification cap they require directly from the insurer. The presence of R&W insurance helps remove many of the historical obstacles to closing a deal – the parties no longer need to argue about the indemnification caps, survival periods and the amount of proceeds to be placed into escrow to secure a purchaser's claim. Instead the amount of cover and survival of the reps will be agreed directly with the insurer. By removing these traditional obstacles, the parties can focus on closing the deal.

How do insurers get comfortable with taking on these risks?

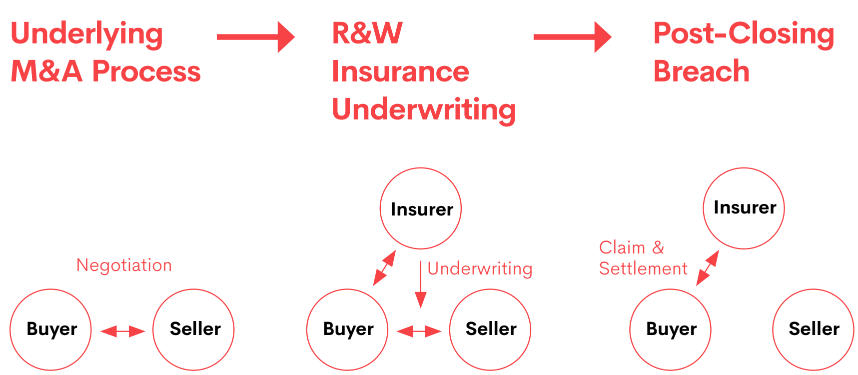
Over the last five years, the R&W insurance market has professionalized. The majority of insurance underwriters are now ex-corporate attorneys, tax lawyers/accountants or investment bankers. They have experience of doing deals and understand how a good process is run. As such, whilst the underwriters are not experts in the underlying sector/ assets involved, they are able to look at how the parties have conducted the transaction to ensure that a thorough due diligence and disclosure process has been undertaken. The knowledge that a comprehensive process has been run provides insurers with the comfort they need to take on the liabilities the seller would usually assume under the purchase agreement with respect to a breach of a representation.

As part of an insurer's underwriting process, it will require access to the virtual data room prepared by the seller, along with access to the purchaser and its professional advisors. Most importantly, the insurer will need access to the due diligence reports that have been prepared in connection with the transaction. At a minimum, insurers will expect there to be legal, financial and tax due diligence. These reports should be in written form and typically prepared by professional external advisers.

R&W insurance should never be seen as a replacement for thorough due diligence and, as such, it is of paramount importance that all of the matters covered under the representations are verified, where possible, by the due diligence reports. That said, due consideration does not mean the purchaser has to go to lengths beyond anything a reasonable purchaser would do.

Insurers will pay close attention to the disclosure process carried out by the sellers and the company and they will need to get comfortable the sellers have fully engaged the management team to prepare and review the disclosure schedules. The vast majority of R&W policies placed today will disregard any limitations with respect to materiality or material adverse effect, notwithstanding that the sellers indemnification obligations (if any) are contingent upon breaching the materiality threshold. It is therefore critical that sellers approach scheduling in a robust manner to give insurers comfort the relevant matters have been included in the disclosure schedules. In addition to robust disclosure, thorough purchaser diligence and a detailed review will provide insurers with the comfort to disregard any materiality qualifiers for the purpose of determining a claim under the policy.

Finally, insurers will be alive to the risk of 'anti-selection' that is applicable to various types of insurance. 'Anti-selection' is the risk of insureds using better information to 'select' the risks it transfers to the insurer. In the context of R&W insurance, this involves requests for only specific representations to be insured, for example FCPA matters or intellectual property infringement. Insurers will be put on notice to anti-selection risk when insureds only require cover for specific representations. It is therefore best not to 'hand pick' representations which the insured wishes to receive cover for – the better approach is to insure all of the representations on the deal.



How much cover is usually purchased and what does it cost?

R&W insurance is rarely taken out to the full enterprise value – policy limits are typically 10–30% of the enterprise value. The premium is expressed as a percentage of the policy limit – this is known as the 'rate on line'. The premium is a single one-off payment for the entire policy period and is normally due shortly after closing with a deposit premium of 10% payable from signing alongside applicable taxes. By way of illustration on a $200 million transaction, a 10% policy limit represents $20 million of cover. At a 'rate on line' of 2.7%, this would represent a single premium payment of $540,000.

The policy will normally contain a self-insured excess. Historically this has been set at 1.5% of the enterprise value and is invariant to the amount of cover purchased. In recent years, increased insurer competition has resulted in lower excess levels – it is often possible to obtain an excess that represents 1% of the enterprise value dropping to 0.5% after 12 months. As outlined in the section below, the seller is typically liable to the purchaser for a portion of the excess, but in some cases this will be carried solely by the purchaser (i.e. the purchaser will not be able to recover the first amount of loss from the seller).

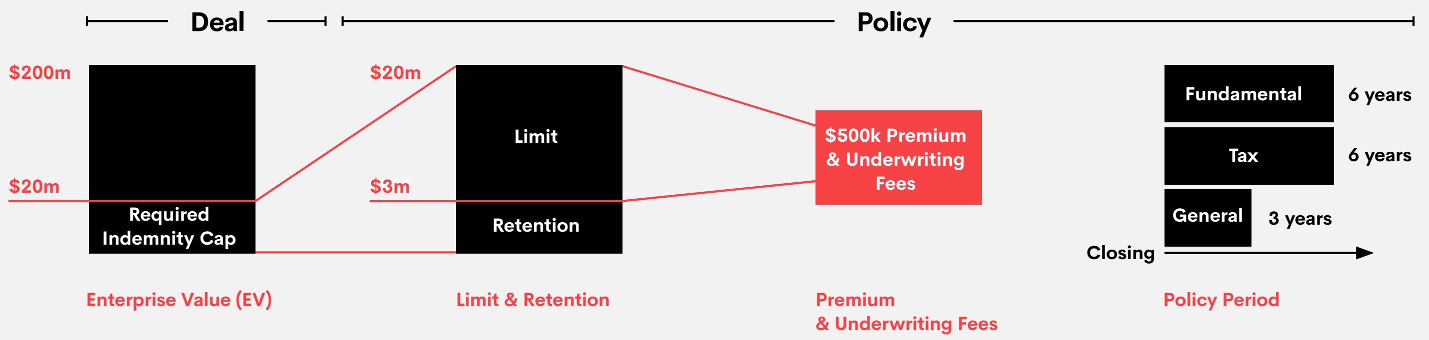
Just in the same way as any seller would do when negotiating with a purchaser, the insurer will set a timeframe following closing within which claims can be made for a breach of a representation – this is the policy period. The policy period will vary depending on the nature of the underlying claim – this is normally three years for general representations and six years for fundamental and tax representations.

As a general rule, the more common the product within a jurisdiction, the lower the pricing will be. In the last couple of years, a number of new insurers have joined the R&W insurance market. The increased insurer competition has led to a decrease in pricing. The table below provides a rough indication of pricing for private equity transactions across a number of jurisdictions.

It is worth reiterating that the policy limit will almost always be a sub-limit of deal value: a 'rate on line' of 2.7% applied to a policy limit representing 10% of enterprise value would result in a premium of 0.27% of enterprise value.

The higher 'rate on line' for deals in North America is attributed to the fact that purchase agreements tend to have more purchaser friendly terms, with representations only qualified by specific disclosures (rather than a general disclosure of the virtual data room) and given on an indemnity basis. The more litigious nature of North American deals also contributes, with purchasers historically more likely to seek recovery from the seller under the purchase agreement. In Asia, greater legal uncertainties coupled with lower insurer appetite contributes to higher rates on line.

Jurisdiction	Rate on line
North America	2.5-3.5%
United Kingdom	0.8-1.5%
Nordics	0.9-1.5%
Western Europe	1.0-1.6%
CEE	1.1-1.8%
Southern Europe	1.3-2.0%
Asia-Pacific	2.0-3.5%



How does cover under the R&W policy differ from the cover provided under the purchase agreement?

Whilst R&W insurance is an incredibly helpful tool in bridging the gap between sellers and purchasers on private equity exits, it is essential that purchasers understand that the cover provided by R&W insurance does not precisely replicate the cover provided by a seller indemnification for a breach of a representation. R&W insurance is designed to cover unknown risks. As such, any matters disclosed within the purchase agreement or disclosure schedules will qualify the cover under the policy. The policy may also be subject to certain market and deal specific exclusions.

With respect to disclosure to the insurer, it must be borne in mind that R&W policies are subject to different duties of disclosure depending on the governing law. Under New York law, this means that the insured (purchaser) owes a duty to the insurer to disclose all material facts and to refrain from making any material misrepresentations.

It is important to make clear that this duty applies to the insured (purchaser), not the seller. In the event the seller has knowingly withheld information or failed to disclose to the purchaser, this will not invalidate the policy. Indeed, even in the event of seller fraud under the purchase agreement (i.e. the seller had fraudulently failed to disclose certain facts and circumstances to the purchaser), the purchaser would still be able to recover from the insurer as long as the purchaser had satisfied its duty of disclosure.

R&W policies typically include standard exclusions from cover. The precise list of exclusions varies from insurer to insurer and from transaction to transaction (depending on the sector/ nature of the underlying asset) and the cover available from the market can differ considerably so prospective insureds should always engage a specialist M&A insurance broker to negotiate on its behalf.

However, as a general rule, the following matters are not insurable:

- the non-availability of net operating losses in the company;
- breaches actually known to the insured's deal team;
- forward-looking statements;
- purchase price adjustments;
- pension underfunding; and
- fines and penalties which are uninsurable by law.

Compliance with FCPA is often an area of focus for insurers, but cover can be obtained if the purchaser can demonstrate that the target company has procedures in place to ensure compliance with the relevant legislation. In addition to the above, insurers will often attempt to exclude liability for, where relevant, issues such as medical malpractice, product liability, data protection and cyber security. The argument here is that the company should have existing policies in place to cover these risks and should not be relying on the R&W policy to provide such protection. However, provided the broker can fully analyze the existing policies in order to evidence that the policies are adequate and robust, it is possible to obtain cover for such matters under the R&W policy (often sitting in excess of the limits on the existing policies).

If representations are repeated at closing, consideration needs to be given to the following: under a R&W Policy, the insured is required to sign a no claims declaration (NCD) at signing (addressing any pre-signing breaches) and again on closing (addressing any post-signing breaches of closing representations). The NCD certifies that the insured's deal team does not have any actual knowledge of a breach of any representations. If any breach first occurs and is discovered in the period between signing and closing, it will need to be disclosed in the closing NCD and will be carved out of cover. Insurers call this 'emergent breach' cover and, at present, they remain largely unwilling to offer such cover.

With respect to breaches which occur before signing but are only discovered in the period between signing and closing, this will be covered by the policy as this will have been a breach of the signing representations. It is worth noting that there is typically no additional premium to cover representations repeated at closing but the gap between signing and closing should typically be less than 90 days and the purchaser should expect to hold a bring down of disclosures call with the insurer.

Even at the heads of terms or letter of intent stage, it is important that the purchaser keeps the restrictions of R&W insurance in mind. With the product's growing presence in the market, it is now common to see low liability caps and an insurance solution integrated into the letter of intent by the seller. However, it is crucial that purchasers understand that agreeing to a low or NIL indemnity cap may leave them exposed to historic liabilities arising from any:

- market or deal specific exclusions;
- 'emergent breaches'; and
- identified issues matters.

As such, it is wise for purchasers to consider whether they should seek recourse against the seller for any matters not covered under the R&W policy. This should be discussed and resolved at the letter of intent stage to avoid any disagreements on this matter during the purchase agreement negotiations.

Covered

- Seller/Company's Representations & Warranties
- Pre-Closing Tax Indemnity

Excluded

- Purchase Price Adjustments (Net working capital adjustment)
- Known Risks
- Market & Deal Specific Exclusions

How does the purchaser make a claim?

In the event of a matter giving rise to a claim under the representations, the purchaser will claim directly against the insurer under the R&W policy. There is no requirement that the purchaser seek to recover from the sellers before claiming under the policy (even if this is possible under the purchase agreement). The seller is often completely cut out of the claims process by the purchaser and the insurer will waive any subrogation rights against them. The only exception to this is where the sellers have been fraudulent. In the event of seller fraud, the insurer will retain a right of subrogation against the seller. Once the insurer has reimbursed the purchaser for its loss (arising from the seller's fraud), it will then be entitled to subrogate against the seller.

The R&W policy will require the purchaser to take reasonable steps to mitigate its loss. This obligation does not require the purchaser to forgo any legal right or breach any legal obligations or do any other thing which would have a detrimental effect on the purchaser. If the purchaser fails to comply with its obligation to mitigate its loss, the insurer may be entitled to reduce its liability under the R&W policy to the extent that the insurer was adversely affected by the purchaser's failure to mitigate.

Although R&W insurance remains a profitable line of business for insurers, claims are on the rise. All R&W insurers are investment grade security, so a much better counterparty exposure than most sellers.

The following case study illustrates how the claims process works in practice:

- On a $200 million deal, the seller warrants that the company's products do not violate, infringe or misappropriate intellectual property rights of any third party.

- The seller caps its liability to $2 million under the purchase agreement. The purchaser obtains its remaining protection under a R&W policy with a policy limit of $30 million in excess of $2 million.

- Nine months post-closing, the purchaser/insured receives notice from a third party alleging infringement of registered patents. Initial investigations confirm the claimant is a well-known patent troll with a history of securing multi-million dollar settlements.

- The purchaser notifies the seller of the breach of warranty and simultaneously submits a claim notice to the insurer, setting out the details of the breach, the potential quantum of the loss and any steps the purchaser intends to take.

- The insurer's consent is obtained to incur defense costs and the purchaser begins negotiations with the third party claimant. The insurer will need to be kept updated on any material developments in the discussions and the purchaser must not settle any claim without the insurer's consent.

- Six months later the third party claimant offers to settle the claim in exchange for a three-year patent license agreement for a fee of $6 million. The insurer's consent is sought to agree to this settlement.

- The insurer agrees to the terms of the settlement. The purchaser recovers $2 million from the seller and the remaining $4 million from the insurer. The insurer also reimburses the purchaser for the $1 million of legal defense costs incurred during negotiations with the third party claimant.

In the above example, the purchaser could have opted to not claim the $2 million from the seller. In this situation, the purchaser would still have recovered $4.5 million from the insurer, but it would have been required to fund the first $2 million of the defense costs and/or licensing fee itself. It is also worth noting that once the $2 million excess has been eroded, all further claims would be paid in their entirety.

How do insurers gain comfort when the seller has no 'skin in the game'?

The product is not immune from the moral hazard risk that affects many types of insurance. Moral hazard occurs when a person takes a higher risk because another party bears the cost of those risks. For R&W insurers, the risk they face is that the sellers take a different approach to the deal, particularly the disclosure process and scheduling.

A thorough disclosure process can be onerous. As such, if the seller has little or no liability under the purchase agreement, they may not be incentivized to carry out thorough and resource intensive scheduling. This leads to the risk that known issues will not come to the attention of the purchaser or the insurer. As R&W insurance is only designed to cover the 'unknowns', a poor disclosure process leaves insurers vulnerable to covering known but undisclosed risks.

Nonetheless, there are a number of ways in which insurers can feel comfortable with sellers having little or no liability. The key point for R&W insurers is that they want to see that a thorough due diligence and disclosure process has been undertaken. The warranty negotiation and disclosure exercise should be conducted on an arm's length basis as if insurance was not being used. The particular dynamics of the deal will also impact an insurer's view of the situation.

For example, insurers gain comfort where:

- the liability cap is low but not so low as to be meaningless to the seller; or
- the seller demonstrate a robust and diligence approach to preparing the disclosure schedules.

It is increasingly common for insured deals to be NIL recourse to the seller and for these deals it is even more important for the sellers to demonstrate a robust disclosure process. Further, in these situations, insurers will expect a reasonable excess to apply to the policy, thereby incentivizing the purchaser to fully establish the facts upfront on the basis it will be exposed to the excess amount in the event of a claim. The final point to bear in mind is that if seller's non-disclosure of known risks amounts to fraud then, notwithstanding the nil indemnity cap for the seller, the seller will still be liable for the full amount of any claim. In such a situation, the insurer also has the right to subrogate against the seller to recover the losses it has paid out under the R&W policy as a result of the seller's fraud.

Conclusion

On a private equity exit, the allocation of risk among the various stakeholders has inherent tensions. The interests of the selling private equity house and purchaser are unaligned when it comes to negotiating the representations set out in the purchase agreement. R&W insurance provides a solution, allowing the interests of purchaser and seller to be more aligned by transferring risk that would otherwise be allocated to the parties, to the insurance market. This helps ease deal negotiations and get deals done, as well as allowing the seller to distribute greater sale proceeds to investors – boosting the internal rate of return. However, the product is not a panacea for all deal issues: purchasers must be aware of the scope of cover afforded by the policy and the parties must understand and plan for the impact of insurance on the deal process.

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