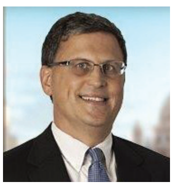
Representations and warranties insurance protects the buyer in merger and acquisition transactions.

BY STEPHEN SAYRE & BRENDAN CAHILL

Coming to a Deal Near You:
Representations and Warranties Insurance



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YOU HAVE REPRESENTED ABC COMPANY FOR MANY YEARS AND SEEN IT GROW from a mom-and-pop operation to having more than $200 million in annual revenues and more than 300 employees. You are of that increasingly rare breed—a corporate generalist—and have represented ABC on its day-to-day contractual matters and during occasional acquisitions.

But now, the first-generation owners have told you that they wish to sell the business. Of course, they want you to represent them in this once-in-a-lifetime transaction. The investment banker they have engaged to conduct the sale process has recommended that the buyer be required to obtain a representations and warranties (rep & warranty) insurance policy as part of the transaction. While you have heard about rep & warranty insurance, you have never come across it on a transaction before. Here are the questions that you need to be able to answer:

What is a rep & warranty policy?

Rep & warranty insurance is an insurance policy almost always obtained by the buyer that insures against losses that the buyer incurs due to the seller's breach of its representations and warranties in the definitive purchase agreement for the acquisition (the "acquisition agreement") and any specifically enumerated ancillary certificates, instruments, or agreements related to the acquisition agreement ("ancillary documents" and, along with the acquistion agreement, the "acquisition documents"). Rep & warranty insurance will also typically provide recourse for buyers regarding traditional preclosing tax liabilities of the company. With respect to breaches of representations and warranties under the acquisition documents, it only covers losses that the buyer does not know about, so expect that the insurance underwriter will devote substantial time to analyzing the due diligence that the buyer has performed. In effect, the underwriter is performing due diligence of the buyer's due diligence. In addition, as the name of this insurance policy descriptively suggests, it covers only breaches of representations and warranties made at the signing and brought down at closing and not breaches of affirmative or negative covenants contained in the acquisition documents.

Rep & warranty insurance is a "claims-made" insurance policy, so claims for losses must be submitted during the policy period. And like other insurance policies, it contains a "retention" amount representing the portion of any loss for which the insured will be responsible. It also includes a policy limit, which places a hard dollar cap on the amount that the insurance carrier can be required to pay on the policy (inclusive of defense costs and all other amounts).

How exactly will it help me?

To help your client appreciate the benefits of obtaining a rep & warranty insurance policy, you may first need to explain some of the liability basics in a merger and acquisition agreement. Your client will need to understand that in a transaction that does not carry rep & warranty insurance, there is, on average, a 10 percent escrow holdback on the purchase price to cover possible seller breaches of the acquisition documents, including the representations and warranties. As will be explained in more detail below, the holdback in a deal that has rep & warranty insurance is dramatically reduced or sometimes eliminated. In addition, your client's risk for any breaches of representations and warranties where the damages exceed the holdback amount is also dramatically reduced or sometimes eliminated (other than for fraud).

How often is rep & warranty insurance used in deals like mine?

Rep & warranty insurance is not new, but it has become much more affordable and the process for obtaining it has become much more streamlined. Insurance carriers have also moved "down market" and are willing to offer rep & warranty insurance on smaller deals. The investment banker has told your client that the ABC Company should fetch between $75 million and $100 million. Five years ago it would have been unusual to see rep & warranty insurance in a deal of this size, but nowadays it's much more likely. In fact, deals as small as $20 million in purchase price may be eligible for rep & warranty insurance. The bottom line is that your client can typically insist that the buyer obtains a rep & warranty policy and exclude any prospective buyer that resists that requirement.

How has the claims history been under rep & warranty insurance policies?

The use of rep & warranty insurance is increasing dramatically. According to a market update provided by Willis Towers Watson, it is estimated that 3,000 policies were issued in 2018, which represents a roughly 19 percent increase from 2017.[1] In addition, according to a 2018 study published by AIG, 19.4 percent of AIG's then-outstanding policies involved a claim, up slightly from the prior year.[2] So, we know that claims are being reported at an increasing rate and that this insurance product is becoming more popular. And, consistent with that, the anecdotal evidence we hear from industry players is that carriers are paying legitimate claims.

But it is important for your client to understand that it is not a party to the policy. Therefore, its liability will be governed by the acquisition documents. There may be situations where a claim is denied, but it pertains to a matter for which the acquisition documents insulate a seller from liability. On the other hand, there may be specific indemnities for which your client is liable under the acquisition documents (typically for liabilities that are known at closing), but for which there are exclusions under the policy. This is sometimes confusing to clients. For most claims, however, there will be no effect on your client if the underwriter denies a buyer's claim.

What is the process for a buyer to get a policy?

The buyer will work with its broker to obtain quotes from insurance underwriters for the policy. The seller will not be part of the quote process. The buyer typically will give the broker the executive slide deck or confidential memorandum describing the

1. Interviews of insurers conducted by Willis Towers Watson Mergers & Acquisitions Group.
2. "Taking Time For M&A Insurance," 2018 edition of AIG Claims Intelligence Series.

TAKEAWAYS >>

• For transactions as low as $20 million, sellers should insist that prospective buyers obtain representations and warranties insurance. Those that resist should be excluded from consideration.

• The seller is not a party to the representations and warranties insurance policy, therefore its liability will be governed by acquisition documents.

• Attorneys representing sellers should review key components with them as they pursue representations and warranties insurance, such as breaches, double materiality scrapes, exclusions, and, of course, fees.

THE USE OF REP & WARRANTY INSURANCE IS INCREASING DRAMATICALLY. ACCORDING TO A MARKET UPDATE PUBLISHED BY WILLIS TOWERS WATSON, IT IS ESTIMATED THAT 3,000 POLICIES WERE ISSUED IN 2018, WHICH REPRESENTS A ROUGHLY 20 PERCENT INCREASE FROM 2017. IN ADDITION, ACCORDING TO A 2018 STUDY PUBLISHED BY AIG, 19.4 PERCENT OF AIG'S THEN-OUTSTANDING POLICIES INVOLVED A CLAIM, UP SLIGHTLY FROM THE PRIOR YEAR.

deal along with the seller's financial statements. At this point, the buyer should ask about the underwriter's requirements, including whether it will require a quality of earnings report or other third-party analyses as conditions to the issuance of the policy. The buyer will also provide the underwriter with a draft of the acquisition agreement, including the list of representations and warranties, typically after the buyer and seller have exchanged one or two rounds of revisions. The insurance broker will typically sign on to the buyer's nondisclosure agreement so that any disclosures made to the broker are protected by the provisions of that agreement.

Based on this preliminary information, the underwriter will put together a nonbinding indication letter, which includes the general terms of the policy: the policy limit, retention amount, premium, deal-specific exclusions, heightened areas of underwriting risk, and the underwriting fee. The underwriting fee typically runs between $25,000 to $50,000, with the actual underwriting fee amount dependent upon a number of factors, including the sector (healthcare, food, energy, and other more heavily regulated sectors typically have higher fees); size and complexity of the transaction; existence of audited financial statements; and availability of written due-diligence reports.

When the buyer selects the underwriter, the underwriter and its advisors will then commence more in-depth due diligence in which they get access to the virtual data room and examine all of the available materials (the underwriters typically outsource this task to a third-party law firm and other advisors, just like a buyer will). The buyer's merger and acquisition attorneys will generally prepare a due-diligence memorandum that walks their client (the buyer) and the underwriter through the steps the attorneys took for due diligence (i.e., what they inspected and what they found). The buyer's broker will provide the underwriter with that due-diligence memorandum and any reports from the buyer's other due-diligence advisors (e.g., tax, environmental, etc.), typically on a nonreliance basis.

Next, an underwriting call is scheduled with the underwriter and its attorneys (if applicable), the buyer and its due diligence team (including the buyer's attorneys and other outside advisors). The seller does not participate in this call. During this time, the underwriter will probe the buyer on areas in which the buyer's due-diligence report has identified possible problems, including to determine whether possible risks warrant a specific indemnity or otherwise constitute a material known issue that should be excluded from the policy. Assuming all goes well on the diligence call, the insurance carrier should be in a position to provide the policy (which would be officially "bound" at signing) within a few days from the underwriting call.

How will this process impact me, the seller?

As noted above, your client should be able to insist that any prospective buyer obtain a rep & warranty policy, and this requirement should be included in the Letter of Intent (LOI). In addition, the LOI may include key terms of the policy, such as the policy amount; the retention amount; the policy exclusions, which may be supplemented based on the results of the buyer's and/or underwriter's due diligence; which representation and warranty breaches may be applied against the retention and the policy (some sellers will insist that any breach of "fundamental reps" be handled outside the policy); and the waiver of the insurance carrier's subrogation rights against the seller in the transaction. The waiver of subrogation is the key "lawyer's point" that the seller will want to confirm is in the policy.

Because the buyer is doing it for both itself and the underwriter, your client—the seller—should be prepared for the buyer's due diligence to be slightly more rigorous than what you may have experienced in other deals. Your client should also expect that additional follow-up due-diligence requests will result from the buyer's

ISBA RESOURCES >>

- Markus May, *Mergers & Acquisitions Corner: Tales From the Trenches*, Business and Securities Law (Nov. 2018), law.isba.org/2I5IBdL.
- William A. Price, *Helping Your Client Buy or Sell a Business*, ISBA Quick Takes video (Mar. 2018), https://youtu.be/EcKrPgdbVTc.
- William H. Mayer, *Eight Common Employee Benefit Plan Failures Discovered During Mergers and Acquisitions*, Corporate Law Departments (Feb. 2015), law.isba.org/2I6zxWb.

conference call with the underwriter.

Your client may find that there is less horse trading on the scope and severity of the representations and warranties because the seller's exposure for breaches is much more limited, which may be positive for the seller and decrease overall legal fees. But, as noted below, your client will need to be mindful of any risk it has with respect to the policy retention. The seller should never agree to any representation that is not true, as insurers always retain the right to subrogate against a seller for seller's fraud.

One additional nuance that may affect a seller's approach to representations and warranties involves knowledge qualifiers. Some buyers attempt to negotiate a "knowledge scrape" with the underwriter, whereby knowledge qualifiers included in representations and warranties are ignored for purposes of determining whether there has been a breach. Where such a buyer is unable to succeed in getting the underwriter to accept the knowledge scrape, that buyer may be much less willing to accept the seller's requests to include such qualifiers in the acquisition documents.

The policy binder should be delivered at signing. If the transaction is a separate sign and close, there is often a seller condition to closing that the policy be delivered in that form at closing and the acquisition agreement should specify that the terms of the policy cannot be altered without the seller's consent. The buyer's counsel should be provided a draft version of the policy binder several days prior to the anticipated signing date to ensure that it comports with the requirements of the LOI, syncs up properly with the acquisition agreement, and is otherwise acceptable to the buyer (see below for what is in the policy itself). In addition, if the seller agrees to be liable for any breaches that are not covered by the policy, the seller will want to closely review the policy's exclusions.

One final comment: By inviting someone else to the party, the buyer and seller may be a bit less free to resolve issues and settle differences, especially if there is a claim after closing. Any updates to the disclosure schedules between signing and closing or amendments to the acquisition agreement will need to be cleared with the insurance carrier. Also, there are some deal terms that can typically be negotiated between the buyer and seller that become much harder for the parties to negotiate if the transaction involves rep & warranty insurance. One example is the double materiality scrape discussed below.

How long is the policy and what is in it?

The typical policy for a deal of this size is roughly 30 pages. It includes a "declarations page" of key terms (i.e., the policy term, the policy limit, the retention amount, and the premium amount) and the players (the insured, the underwriter, and the broker). The policy amount is typically 10 to 20 percent of the purchase price and the premium amount is typically 2 to 3 percent of the policy amount. The policy term will be staggered to correspond with the different limitations periods in the indemnification section of the acquisition agreement. However, the policy period for nonfundamental representations generally will be three years, which is longer than the 12- to 18-month-limitation period typically contained in the acquisition agreement, giving the buyer time to consider filing a claim. The policy term for fundamental and tax representations will typically be six years—even if these representations and warranties are not subject to a specific time limit in the acquisition agreement.

The retention amount under the policy is typically 1 percent of the transaction's enterprise value, though it could be higher if the policy holder wishes to reduce its premium. In addition, in the current market the retention amount typically decreases to one-half (.5) percent of the enterprise value after the general representations expire in the purchase agreement (typically 12 or 18 months). In most cases, the acquisition agreement will provide that the buyer and seller split the retention amount, with the buyer having no recourse to the first half of the retention amount (akin to a traditional "true deductible basket") and the seller having exposure for the second half of the retention amount, which is usually escrowed. But this can be negotiated to make the buyer responsible for 100 percent of the retention (typically referred to as a "no seller indemnity" situation). Whatever the risk-sharing arrangement is, it should be set forth at the outset in the LOI.

The policy will provide that it covers any "losses" due to any "breaches" of representations and warranties set forth in the acquisition documents (and, as noted above, typically a traditional preclosing tax indemnity). These terms are defined in the policy and typically sync up with the definitions of these terms in the acquisition documents, such that, for example, if the acquisition documents are silent on the recoverability of consequential damages for a breach of a representation and warranty under the acquisition documents, the policy should also be silent on such a point. If they do not align, the differences should be discussed and understood. In addition, and as noted above, the policy coverage is

YOUR CLIENT—THE SELLER—SHOULD BE PREPARED FOR THE BUYER'S DUE DILIGENCE TO BE SLIGHTLY MORE RIGOROUS THAN WHAT YOU MAY HAVE EXPERIENCED IN OTHER DEALS. YOUR CLIENT SHOULD ALSO EXPECT THAT ADDITIONAL FOLLOW-UP DUE-DILIGENCE REQUESTS WILL RESULT FROM THE BUYER'S CONFERENCE CALL WITH THE UNDERWRITER.

limited to representations and warranties and does not typically address covenants (other than a traditional preclosing tax indemnity).

Buyers typically want the policy to provide that the determination of whether or not there has been a breach of a representation and warranty—and the extent of any resulting losses—be determined without regard to any materiality qualifiers contained in that representation and warranty. Because underwriters typically only agree to a double materiality scrape if such a scrape is also in the acquisition agreement, buyers traditionally push for the acquisition agreement to also contain a “double materiality scrape” providing that the materiality qualifiers will be similarly ignored in determining whether there is a breach of any representation or warranty under the acquisition agreement and the extent of any losses in connection with a breach.

At first blush, this would seem to completely negate the impact of the materiality qualifiers you have been fighting for during the negotiation of the acquisition agreement. You will need to explain to your client that it will still benefit from those materiality qualifiers in bringing down its representations and warranties at closing, thereby helping your client to close notwithstanding a “nonmaterial” breach of a representation and warranty where such a qualifier has been included. Of course, because the covenants are not subject to the policy—or the double materiality scrape—the materiality qualifiers will still be important to your client with respect to those obligations.

There will be a section of the policy that sets forth the exclusions from coverage. It is quite common for the policy to exclude liabilities associated with underfunding of employee benefit plans and withdrawal liability from multiemployer plans. There are also exclusions that directly or indirectly address known problems or issues that have arisen during due diligence (i.e., items for which the seller has been asked to provide a specific indemnity, issues or problems noted in the seller’s disclosure schedules, the buyer’s due diligence report, or any other breaches of which it can be shown members of the deal team had actual knowledge). Exclusions may also arise from the buyer’s failure to conduct commercially reasonable due diligence on a certain aspect of the business (e.g., international operations). Should such an exclusion arise, the seller may want to push back on being liable for these losses given that it was ultimately the buyer’s decision not to conduct such due diligence.

The policy will provide that losses be reduced by “recovered amounts,” such as the buyer’s recoveries from other insurance policies or any tax benefit that might accrue to the buyer due to the loss. Because such recovered amounts are customarily netted against recoverable losses under the policy, but may or may not be netted against indemnification claims in the acquisition agreement, there could be a situation where there is a mismatch between retention depletion and the amounts of recoverable claims under the acquisition agreement. Any such mismatch should be noted and understood by your client.

As noted above, you should also confirm that the insurance carrier’s standard subrogation clause is waived as to the seller in connection with the acquisition agreement and the transaction contemplated thereby other than with respect to fraud. This is typically in the policy without negotiation.

Do I need to hire an attorney who has experience in this area?

If you are an experienced mergers and acquisitions attorney, you should not let the additional complication of rep & warranty insurance dissuade you from representing your client in the transaction on the sell side. The tremendous institutional knowledge that you have about your client and the trust you have established will be crucial to getting your client over the finish line. But we would recommend that this be viewed as an area where subject-matter experts should be used. Where, in the past, you might engage an environmental or employee-benefits attorney to assist on those issues for a deal, you should now also strongly consider engaging an attorney with rep & warranty insurance experience. The buyer will undoubtedly have an attorney that has experience with rep & warranty insurance. Therefore, you will need such expertise on your side.

You are now ready to take that call. Good luck with the deal! IBJ