

THE STRATEGIC USE OF REPRESENTATION AND WARRANTY INSURANCE IN M&A TRANSACTIONS

BY EVA DAVIS AND JONATHAN GILBERT

The market for M&A deals in the US is on the rebound after a sluggish 2013, with the first and second quarters of 2014 being some of the most active quarters since the 2008 financial collapse. Today's M&A market is fueled by readily available acquisition financing on favorable terms, the largest "overhang" of private equity dry powder in US history, and excess cash on the balance sheets of US strategics. These conditions have heated a "sellers' market" where targets are frequently sold through an auction process with multiple bidders and high valuations. In this very competitive market, a buyer can strategically use representation and warranty insurance (R&W insurance or policy) to best position its bid in an auction. In that same market, a seller can be afforded greater certainty of sale proceeds by offering a "stapled" R&W insurance policy to be purchased by the buyer.

R&W insurance protects an insured from unanticipated and unknown losses that arise subsequent to the closing of an M&A transaction from breaches of a seller's representations and warranties. Either the buyer or the seller can be insured under the policy. However, as described below, since losses actually known to any insured are not covered under R&W policies, it is usually more beneficial for a buyer (who is less familiar with the target than a seller) to be the insured under a R&W policy. More recently, R&W insurance has been used as a strategic tool in auctions for the seller to get the best deal terms or for a buyer to offer the superior bid.

In recent years, the use of R&W insurance has increased dramatically due to reduced costs, broader terms, positive claims experiences and ease of underwriting process. First, the cost of R&W insurance has decreased, on average, to approximately 2 to 3.5 percent of insurance purchased – paid as a one-time, lump-sum premium at closing. Second, after years of buyers and sellers negotiating with insurance companies, R&W policies now provide narrower exclusions and higher limits of liability. Third, over the past 15 years, hundreds of millions of dollars of claims have been paid out for breaches of representations and warranties, resulting in more deal professionals supporting the view that R&W insurance has been "fire tested." Fourth, the process for obtaining R&W insurance has significantly improved with many policies being bound over one to two weeks, accelerated when needed. As a result, the deal community is

much more accepting of R&W policies and transaction parties are much more willing to incorporate R&W insurance from the outset of deal negotiation rather than in the final stages of a transaction

With or without the knowledge of seller, a buyer can choose to strategically use R&W insurance in order to distinguish its bid in a competitive auction. With the comfort that R&W insurance can be secured to mitigate the risk of seller's breaches of representations and warranties for agreed-upon time periods, coverage amounts, retention amounts (deductibles) and other negotiated terms, the buyer is then well positioned to accept indemnification from a seller on very limited terms (e.g., modest survival periods, liability caps and escrow amounts). The buyer also has the added benefit of obtaining deal protection from a more financially viable entity (a AAA rated asset).

A seller can also choose to strategically make R&W insurance available to a buyer in order to obtain the best offer from each bidder in an auction. Similar to "stapled financing" offered in leveraged buyouts, a seller pre-negotiates the terms of the R&W policy with an insurance company. If ultimately purchased by a buyer, the pre-negotiated R&W policy provides funds to the buyer to cover seller's breaches of representations and warranties for agreed-upon time periods, coverage amounts, retention amounts and other negotiated terms. With the pre-negotiated policy, seller signals to the buyer that the buyer must offer the best purchase price and other terms to the seller given the limited scope of indemnification seller is willing to provide but knowing that R&W insurance is available (should any bidder choose to purchase the coverage). Through this process, seller is able to maximize its dollars on exit and minimize any dollars it may have to return to buyer (through an escrow or otherwise) following exit.

R&W insurance does not mirror what is or would customarily be contained in a seller's indemnification covenant in a purchase and sale contract. Some policy provisions are more expansive than customary indemnification terms, thus providing the insured with more coverage, and other provisions are narrower providing less coverage. Since the cost of the policy increases with coverage amounts and policy periods, an insured may choose coverage less than would typically be offered by a seller

as indemnification for certain breaches. For example, breaches of “fundamental” representations relating to the ownership of stock in the target would customarily be indemnified by seller in an amount up to the purchase price and often for an unlimited period, but an insured may choose to seek indemnification resulting from this breach for 20 percent of the purchase price for up to seven years (generally, the longest coverage period offered in R&W insurance). The insured may, however, seek more coverage than the seller is offering on the “operational” representations – for example, for up to 20 percent of the purchase price for three years (rather than 5 percent of the purchase price for 15 months). While theoretically a buyer or seller could seek to negotiate a policy where the seller is not at any risk under the R&W policy, insurance companies will usually provide better policy pricing if the seller is responsible for covering some portion of the losses, which the insurance company views as minimizing the seller’s “moral hazard” risk.

When R&W insurance is used as a strategic tool, the retention amount under the R&W policy for breaches of representations (during the survival period for those same representations under the purchase contract) is often the indemnification cap or escrow amount provided by the seller for those representations with a potential step-down in the retention amount following the expiration of that survival period or escrow period. For example, if the operational representations survive 15 months and a seller’s indemnification obligation for breaches of those representations is capped at 5 percent of the purchase price, a buyer will often only seek R&W insurance for losses in excess of such 5 percent cap provided by seller during that 15-month period (essentially making seller’s 5 percent cap the retention amount under the policy) and potentially reducing that retention amount following the 15-month period when the buyer no longer has indemnification protection from the seller. Alternatively, the buyer may look offer to reduce the escrow to one to two percent of the purchase price and use R&W insurance as additional coverage.

Just as a buyer can seek to negotiate indemnification terms with a seller, a buyer can negotiate insurance provisions with the insurance company. Several provisions can be negotiated in a manner that would typically be considered “buyer favor-

able,” including whether consequential damages, lost profit or multiple of earnings damages will be covered.

The “actual knowledge” of a handful of named deal team members at the insured (with respect to any breach by a seller) limits coverage. While this limits potential recovery under R&W insurance, it is generally better for a buyer to seek to be the insured under any R&W policy rather than the seller, as seller’s “actual knowledge” would typically be much greater. “Actual knowledge” will include third party professionals findings in due diligence reports related to the M&A transaction. As part of the underwriting process, the insurance company will require access to these reports, the full online data room, and other material information provided by the seller to the buyer in the transaction. In addition, while all representations and warranties can potentially be covered, R&W insurance is not meant to replace risks customarily addressed through other insurance policies, such as product liability and directors and officers liability. Typically, a R&W policy will include an “other insurance” provision to ensure the policies customarily covering these risks are the policies to respond first. Often times, when significant environmental concerns exist, known issues will be excluded or the environmental representation will be excluded altogether. Under these circumstances, buyers will typically seek traditional risk transfer through a pollution legal liability policy. Additionally, since financial and tax representations have been the most common source for claims in this market segment, they are an area of particular focus during underwriting. .

R&W insurance, which has historically been compared to “big-foot”, a feared creature often talked about but never seen, is today viewed as a valuable deal solution. Whether a seller is looking to limit its exposure post-sale or a buyer is seeking to enhance its bid in a competitive investment climate, R&W insurance is a cost-effective, user-friendly and efficient tool to allow buyers and sellers to consummate transactions by mitigating uncertainty, enhancing bargaining or bid positions and ultimately helping to protect the return on investment or sale proceeds.

Eva Davis is Chair of West Coast Private Equity at Winston & Strawn LLP, and Jonathan Gilbert, is the M&A Practice Leader, at Crystal & Company

AS FEATURED ON

The Deal
Pipeline

TheDeal.com (ISSN 1547-7594) is published by The Deal.
© Copyright 2014 The Deal. The Copyright Act of 1976 prohibits the reproduction by any means of any portion of this publication except with the permission of the publisher.

WWW.THEDEAL.COM