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Current Trends in Representation and Warranty Insurance

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In any business acquisition, the lure of great profit is accompanied by the specter of risk. For mergers and acquisitions practitioners, the allocation of unknown business risk between the buyer and the seller is generally one of the most contentious aspects of a deal negotiation. Although both sides place great value on the cash flows from the target business, neither party wants to be responsible for hidden compliance violations, unpaid back taxes or valuation missteps caused by financial statement errors. Historically, the parties that were willing to hold transaction risk were limited to those with a direct interest in the deal: the buyer and the seller. In the past decade, however, a segment of the insurance industry has started shouldering a piece of the risk in M&A deals for a price.

Representations and warranties (R/W) insurance policies are now offered by a broad range of underwriters. These policies allow buyers and sellers to shift a portion of transaction risk to third-party insurers. These policies typically come in two distinct forms: "seller-side" policies and "buyer-side" policies. Although similar in many respects, buyer-side policies are more common in the market, as they eliminate the need for the buyer to assert claims beyond the insurance policy “retention” (akin to a deductible) against the seller before pursuing recovery under the policy. Despite its name, it is not uncommon for sellers to require the use of a buyer-side policy in a sale transaction as a way to maximize unencumbered closing proceeds.

With a buyer-side R/W policy, if there is a breach of one of the seller's representations or warranties in the purchase agreement, the buyer is able to recover the resulting losses from the insurer. Like other insurance policies, a retention must be eroded by claims before coverage is provided. Retention amounts of between 1 and 1.5 percent of enterprise value are typical for deals over $50 million, with a 2 or 3 percent retention not unusual for a $25 million transaction. In a common scenario, the insurer will price the coverage assuming that the buyer and seller will each bear half of the retention. This gives the buyer incentive to do thorough diligence and the seller incentive to actively negotiate the reps and warranties. In many cases, the retention will "step down" to half the original amount after 12-18 months, with only the buyer's share of the retention remaining after that point. For sellers, this frequently means that they can walk away from a transaction leaving behind only 0.5 to 1 percent of the purchase price in escrow for 12-18 months, with the escrowed amount representing their entire transaction exposure (except in the extraordinary case of fraud).

Underwriters currently offer a broad range of coverage amounts, with insurance in excess of $500 million readily available. On the other end of the spectrum, policy amounts below $5 million are generally not economical for the insurers. As such, assuming a buyer will want coverage equal to at least 10 percent of enterprise value, finding insurance for deals below $50 million of enterprise value is difficult. However, an increasing number of parties have started recognizing value in freeing up closing proceeds with insurance and are willing to buy a $5 million policy for transactions with values below $50 million.

While a variety of factors can impact the cost of coverage (e.g., the nature of the business being sold and the size of the deductible), R/W insurance typically costs between 3.5 to 4.5 percent of the policy limit, including the premium, fees and taxes. For example, a $10 million policy typically costs between $350,000 and $450,000. This is a one-time expense. Of this amount, $25,000 to $45,000 is the underwriting fee, which is paid to the insurance carrier in advance of closing to allow them to hire outside counsel to help them underwrite the transaction. The balance is paid at closing. For example, assuming a typical policy with a limit equal to 10 percent of enterprise value, the cost of coverage is 35bps to 45bps.
In exchange for this added expense, a significant portion of the sale proceeds is freed up at closing. With the influx of new carriers into the R/W insurance market, pricing has trended downward. While it is unlikely that policy costs will sink below the low-end of the range noted above in the near future, the increase in competition in recent years has forced insurers to become more accommodating to purchasers, both in terms of pricing and coverage.

American International Group Inc. has a substantial presence in the R/W insurance market. In a January 2016 report, AIG noted that, during the 2011-2014 period, claims were made against 15 percent of policies written for transaction sizes of $100 million or less. Claim rates were only slightly lower for transaction sizes above this threshold. The most frequent source of claims was financial statement issues, followed by taxes, contract matters and intellectual property issues.

A buyer-side R/W insurance policy offers benefits to both sides in a transaction.

For buyers:

- Buyers get comfort that they have recourse against a creditworthy insurer that wants to avoid a reputation for denying worthy claims.
- In an auction situation, a buyer can include a R/W insurance policy as part of a bid to help distinguish its offer.
- Buyer-side R/W policies commonly offer longer survival periods (i.e., period of time in which a counterparty can assert a claim) than those in a typical market purchase agreement. A typical policy provides three years of coverage for general representations and six years of coverage for fundamental and tax representations.
- Because the seller's exposure is significantly less than in an uninsured deal, buyers may find that sellers are less inclined to fight tooth-and-nail for specific contract points (e.g., definitions of “loss” and materiality scrapes).
- Currently, the trend among underwriters is to provide buyers with the potential to make a claim for "multiple of EBITDA" or "multiple of earnings" type damages, which are typically resisted by sophisticated sellers.
- With a financially distressed seller, a R/W policy can provide a means of recourse to a buyer when indemnification rights against the seller are basically meaningless.
- Finally, in some transactions, management sellers become part of the buyer's team after closing, and a R/W insurance policy allows a buyer to assert a claim against a third-party insurer rather than against one of its insiders.

For sellers:

- A R/W insurance policy allows sellers to walk away from a deal leaving a relatively small portion of the purchase price at risk for only a short period of time.
- For private equity funds nearing the end of their life cycle, a R/W insurance policy can help provide certainty with respect to the fund's liquidating distributions.
- A R/W insurance policy can mitigate concerns that minority sellers may have about being joint-and-severally liable for indemnification claims.

Buyer-side R/W policies can be a good fit in many M&A transactions. However, a transaction that includes a R/W insurance policy must be carefully structured to appropriately shift the claim risk to the third-party insurer. Some fundamental changes to a typical purchase agreement are generally needed to reflect the structure, and the insurance policy and declarations must be scrutinized to ensure that the underwriter is providing all of the coverage that the buyer expects.