Representation and Warranty Insurance: No Longer Optional

Deal Terms and Trends
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MARSH

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1 Introduction

Representation and warranty insurance (R&WI) has become an integral component of the M&A landscape and is here to stay. The data speaks for itself: in 2014, more than 700 U.S. R&WI policies were issued, which was double the amount of policies issued in 2013 and quadruple the amount of policies issued in 2012. M&A deal professionals who don't understand the product, and its strategic uses and pitfalls, risk being left behind.

The projected growth for 2015 is up to 20 – 30%.

Why has R&WI become so popular? In the classic battle over the indemnity package between the parties to an acquisition agreement, buyers want very broad coverage for all pre-closing issues that could arise following the transaction and sellers want no or very limited exposure as they exit their investments. R&WI helps, for a price, to bridge this gap and permits both buyers and sellers to achieve their objectives.

However, R&WI is not a one-size-fits all, complete solution for risk allocation, and the approaches and policies will differ from deal to deal depending on the industries involved and transaction specific issues. Furthermore, the R&WI market, which is continually evolving and dynamic, is influenced by, among other things, maturation of underwriting models, evolution of key deal terms, claims history and the increasing demand for the product.

The effective use of R&WI requires not only an intimate knowledge of the product but also an understanding of the interplay between the policy and the acquisition agreement. Experienced deal professionals – M&A lawyers and insurance brokers – are vital to ensure seamless and timely integration of the product and should be consulted before negotiating or proposing any indemnity and insurance package.

Dechert and Marsh have helped clients negotiate, implement and strategically use R&WI products for years. With the increasing maturity of this product and its continued popularity, certain "market" terms are becoming apparent – some of the more significant trends are discussed in this study.

2 Basics of Representation and Warranty Insurance

R&WI generally functions as a substitute for a portion or all of a seller's indemnification obligations for breaches of representations and warranties in an M&A transaction. Although the markets are dynamic, as of the release of this study, these policies usually do not cover losses for breaches of covenants (other than with respect to pre-closing tax indemnification), or purchase price adjustments.

Although sell-side policies – in which the seller obtains coverage against having to give sales proceeds back to the buyer – are available, buy-side policies – in which the buyer obtains coverage for losses related to inaccuracies or breaches of the seller's or target's representations and warranties – continue to be much more prevalent in the M&A environment. A phenomenon that the following statistic does not portray is the fact that a significant portion of buy-side policies are initiated by the seller and its advisors, strongly suggesting to potential buyers that consideration of the utilization of R&WI is paramount in order to remain competitive in an auction process.

In 2014, over 80% of R&WI policies purchased were buy-side policies.

A typical R&WI policy will cover the insured's losses over a specified deductible, which is called a "retention amount" in R&WI terminology (i.e., coverage is not available for the first dollars of loss). The retention amount depends on various factors but rarely is less than 1%, and is more often 1.5-2.0% of the total deal value (i.e., not of the coverage bought under the policy). In some policies, the retention amount is reduced after a specified period of time. This "retention drop-down" has become fairly commonplace. We typically see the drop-down between the 12 and 18 month anniversary of the closing of the transaction. This drop-down generally aligns with the expiration of the general survival period for representations and warranties in the underlying acquisition agreement. Even with the drop downs, the lowest retention amount will usually hover between 0.5% and 0.75% of transaction value. Insurers' preference, and often a prerequisite, is for the seller to share in at least a portion of the retention amount for 12 to 18 months, demonstrating that the seller has some "skin in the game," in order to mitigate the moral hazard inherent in insuring a third party's representations and warranties. The relatively small exposure of the seller in these scenarios has resulted in significantly lower amounts, if any, to be placed into indemnification escrow accounts. Escrows traditionally ensured that the seller would have liquid funds available to satisfy indemnification claims.

Insight

Traditional indemnification provisions will typically require that some percentage of a seller's proceeds be placed in escrow, which often acts as a cap on the seller's indemnification exposure for breaches of non-fundamental representations and warranties. According to the 2013 Houlihan Lokey Purchase Agreement Study for transactions completed in 2012 and prior years (the Houlihan Study), the size of the average indemnity escrow in 2012 was 7.6% of transaction value and the average cap in 2012 was 13.5% of transaction value. The 2013 ABA Private Target Mergers & Acquisitions Deal Points Study (the ABA Study) came to similar results, with an average indemnity escrow in 2012 of 7.8% of transaction value and the average cap in 2012 of 16.6% of transaction value. According to the 2014 SRS/Acquiom M&A Deal Terms Study (the SRS Study), the size of the average indemnity escrow in 2013 was 11.8% of transaction value and, in 85% of transactions, the cap was equal to the escrowed amount (SRS Study). Our more recent experience is that the average escrow amount has come down further and often serves as the cap for breaches of non-fundamental representations and warranties. These escrows are typically not released until the survival period applicable to the general representations and warranties has expired, which usually occurs between 12 and 24 months after closing (the median general survival period in the SRS Study for 2013 and in the Houlihan Study for 2012 was 18 months, and 83% of the transactions in the ABA Study had general survival periods of 12 months, 18 months or somewhere in between). However, under this structure, the seller often remains liable for the breach of certain "fundamental" and tax representations and warranties.

Now, with the introduction of R&WI policies, escrows often serve that purpose only for the seller's portion of the retention amount or, where specific liabilities have been identified – which are typically excluded from coverage of an R&WI policy – to be a backstop for losses caused by those liabilities. However, the market has increasingly provided insurance in public-style/no indemnity deals. In those situations, the buyer is generally subject to a retention amount of 1.5% – 2.0% of the total enterprise value of the target.

The losses covered by R&WI policies are subject to a specified coverage limit, which is set by the insured (with the approval of the underwriter) and reflects the insured's risk appetite. The coverage limit is the threshold up to which the insured is willing to pay for coverage and above which the insured either "self-insures" or obtains recourse – mainly for fundamental representations – against the seller. On occasion, when dealing with risk-averse buyers, the coverage limits have been as high as 100% of the total deal value.

Any indemnification obligations outside of an escrow are subject to collection risk – and, in many cases, this risk is exacerbated once the transaction proceeds have been distributed by the seller to its equity holders. In addition, if a financial buyer makes an indemnification claim and collects from the continuing management team, who were sellers in the transaction, the tension between the new owner and management can negatively affect the business.

In contrast, R&WI policies typically do not present the same collection risk issues as the policies are issued by reputable third party insurers and generally do not provide recourse for the insurer against the sellers, as subrogation is often limited to fraud. Additionally, R&WI policies generally provide coverage for policy terms of three years for "general" representations and six years for "fundamental," tax and employee benefits representations.

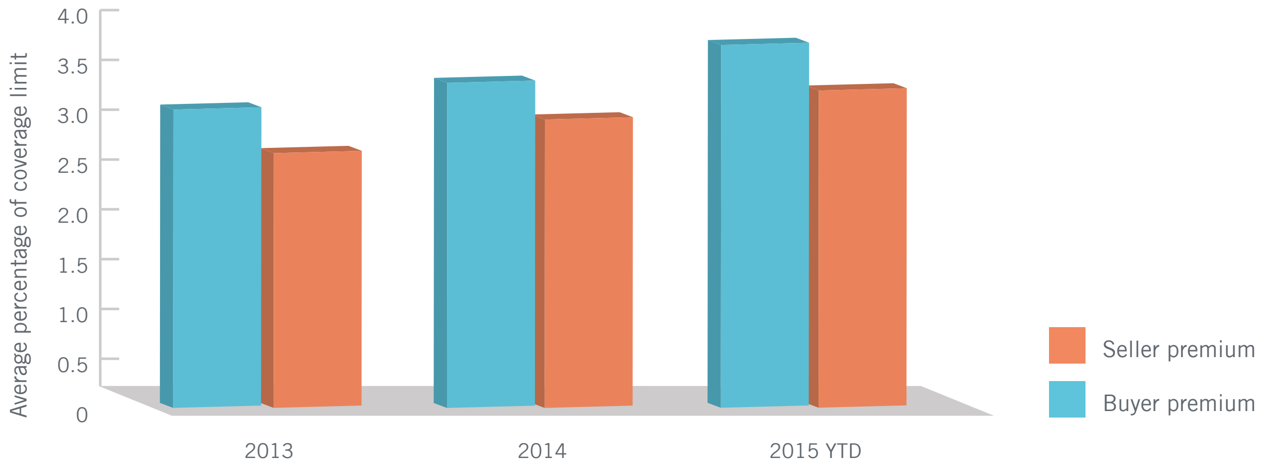
An additional benefit is the receptiveness of the seller to the need of reasonable, broad representations and warranties that, in connection with a traditional indemnification package, often involve protracted and agonizing negotiations. The broader breadth of the representations and warranties combined with (1) a tailored coverage limit that is often higher than what a seller would be willing to provide, (2) longer survival periods and (3) potentially lower risk of collection, in each case, relative to typical transactional indemnification provisions, gives a buyer insured by an R&WI policy a greater level of protection with respect to these points than a buyer relying on a traditional escrow-based indemnity.

3 Size of the Policies and Premiums

Policy coverage limits range from as low as $5 million (although policies with limits below $10 million have become increasingly more difficult and expensive to obtain) to as much as $350 million (to a large extent limited by the availability of underwriting capacity).

Compared to the late '90s/early '00s when the first R&WI policies were available, average premiums for R&WI policies are substantially lower – although the pricing has, mainly due to widely accepted policy enhancements, firmed up over the last two years. In the current market, a buyer should expect to pay a one-time premium of approximately 3.25% to 4.0% of the coverage limit for a policy with a coverage limit between $10 million and $40 million and with a low retention amount (generally 1.25% – 2% of the transaction value). The premiums tend to be appreciably lower (as a percentage of the coverage obtained) for policies that have significantly higher coverage limits and marginally lower for policies with higher retention amounts.

Evolution in premiums



4 Claim Payouts

While most R&WI policies do not experience "real" claims (i.e., claims that would, if they were accepted, exceed the retention amount), **it has been our experience that R&WI policies perform as expected when such real claims arise**. According to AIG's Representation and Warranties Insurance Claim Review from November 2013, AIG received claims on 28% of their North American R&WI policies, which also tallies all of the claims insureds made to merely start eroding the retention amount, insurance terminology for being counted towards the deductible. We estimate that the number of real claims has been between 5% and 10% of the R&WI policies, which is consistent with the 2015 SRS/Acquiom M&A Claims Study that reports 25% of transactions had more than one claim (SRS included purchase price adjustment disputes as a claim) and reports 6% of transactions had claims that matched or exceeded the applicable escrow.

"AIG paid three claims in excess of $20 million in 2014 for financial statements related breaches and over $100 million for R&WI related claims around the world."
– Jay J. Rittberg, Senior Vice President and Americas M&A Manager, AIG

In a recent acquisition, a buyer acquired a target and utilized an R&WI policy issued by Concord Specialty Risk ("Concord"). After closing, the buyer discovered that the seller's financial statements representation had been inaccurate and, if they had been accurate, the target's EBITDA would have been lower. Accordingly, the purchase price, which had been calculated as a multiple of EBITDA, would have been lower. The buyer made a claim under the R&WI policy, and within days Concord conceded the occurrence of a "breach."

"The buyer and Concord investigated the magnitude of the damages (including the degree to which future EBITDA would be adversely affected) and amicably resolved the claim using a multiple-based calculation amounting to approximately $7.5 million above the applicable retention amount, which Concord then promptly paid."
– David S. De Berry, CEO, Concord Specialty Risk

5 Obtaining and Negotiating a Policy

To initiate the process, the insurance broker coordinates quotes from several underwriters that indicate premiums and potential exclusions from coverage. Typically, a couple of weeks prior to signing a definitive agreement, the party obtaining the insurance will begin providing diligence reports and drafts of transaction agreements and related documents to the chosen underwriter. As discussed, we have increasingly seen sellers and their advisors – particularly in the auction context – suggest the utilization of R&WI from the launch of the sale process. In those auctions, preliminary, non-binding quotes and terms from underwriters (that have been solicited by the seller's broker) together with general information about buy-side R&WI policies are made available to prospective buyers and are conceptually reflected in the auction draft of the acquisition agreement.

While the underwriters will not reinvent the wheel and start their due diligence from scratch, they expect to piggyback on the due diligence reports prepared for the buyer (in the case of buy-side R&WI policies) and any offering materials prepared by the seller. The underwriters' review of the material is quick – concentrating on particular areas of concern, either raised in the reports or risk factors or based on the underwriters' industry experience. The review by the underwriters of the written materials is generally followed by underwriting calls with the insured and certain of its advisors. Contemporaneously with the underwriters' due diligence review, counsel and broker to the insured will negotiate the terms of the R&WI policy with the insurer. These terms are inextricably linked to the due diligence findings and the terms of the acquisition agreements and require careful drafting. As discussed, insurers may exclude coverage for breaches of certain representations and warranties and every policy excludes coverage for breaches actually known by the insured (i.e., express sandbagging will not be permissible).

Policies can be bound at either signing (if closing is to occur subsequent to signing, binding at signing will require that a non-refundable portion of the premium is paid at signing) or at closing. Note that R&WI policies will exclude coverage for any breaches occurring between signing and closing that become known by the specified knowledge parties during such period. However, certain insurers will permit such "interim breaches" to erode a portion of the policy retention amount if the insured pays an increased premium.

As detailed in the next section, the R&WI policy will reflect many terms of the acquisition agreement. Often overlooked provisions that the deal team needs to make sure synch between the policy and the agreement are the claims procedures and settlement provisions in the acquisition agreement and the R&WI policy.

6 Scope of Coverage

Various factors impact the scope of an R&WI policy's coverage – some are industry-specific based on the operations of the target company, some are factual and some are contractual.

Industry Sensitivities. Based on their inability to reasonably assess the risk of certain industries, many underwriters are unwilling to underwrite R&WI policies for transactions covering certain industries – most notably, healthcare (with sizeable exposure to Medicare/Medicaid reimbursements), mortgages, insurance, and fracking and other high environmental impact industries. Preparing for these sensitivities with counsel and other advisors is critical to making the appropriate strategic decisions early in a process – for example, pursuing a truncated policy excluding coverage for any area of concern (which is rarely obtainable), conducting even more extensive due diligence and self-insuring, or entering into creative risk-sharing arrangements with the sellers.

Excluded Representations. As the insurers' underwriting models have matured, the representations and warranties that are excluded from coverage have evolved. For instance, insurers have recently been reluctant where signs of heightened risk have been identified during the underwriting process to insure a party for breaches of representations and warranties relating to the wage and hour/FLSA claims, the classification of independent contractors, the underfunding of pension liabilities, and the sufficiency and post-closing availability of net operating losses. In addition, asbestos and PCB related losses have been, and continue to be, excluded.

Knowledge. Generally, insurance policies provide coverage for unanticipated and unknown losses that arise after the policy has been bound. As a result, those policies will not cover losses of which the insured knew at the time the policy is bound – for example, one would not be able to obtain fire insurance for an already burning house. Consequently, R&WI policies exclude losses that result from the inaccuracy or breach of a representation or warranty of which the insured knew at the time the policy was bound. On the margins there is room for negotiation as to the definition of knowledge and the knowledge group. However, unlike in a traditional indemnification package, an insured will not be able to contractually obtain a pro-sandbag provision. Similarly, R&WI policies will expressly exclude preexisting, transaction specific conditions and exposures that have been identified during the buyer's due diligence process.

Loss. Since R&WI policies insure the representations and warranties of the referenced acquisition agreement, underwriters strongly prefer – and deviation is rare – to match all indemnification related provisions in the underlying acquisition agreement (assuming the acquisition agreement is not a "naked, no indemnity deal"). Most notably, if the acquisition agreement contains a definition of "loss," the R&WI often incorporates that definition by reference. Therefore, it is critical to pay close attention to the connected intricacies between the policy and the acquisition agreement, e.g., the importance of explicitly including consequential and other types of damages (or, at a minimum, being silent on such types of damages), or the scrape of materiality qualifiers contained in the acquisition agreement's representations and warranties.

Consequential damages were expressly excluded in 2012 in 54% of the transaction in which the representations and warranties survived the closing (ABA Study). In 2013, consequential damages were not addressed in 71% and explicitly excluded only in 23% of acquisition agreements (SRS Study). In 2012, a double materiality scrape was only included in 11.5% (ABA Study). In 2013, a double materiality scrape was already included in 15% of acquisition agreements (SRS Study). We have found that double materiality scrapes are common in deals with R&WI and that most of them remain silent with respect to consequential damages and the calculation of applicable losses based on a purchase-price-multiple.

7 U.S. Policies From a Global Perspective

U.S. R&WI policies tend to be more expensive than policies underwritten abroad, e.g., in Europe or Australia – but as one insurance professional put it "You get what you pay for." The most notable difference is the very expansive breadth of the knowledge exclusion typically contained in UK-style policies. While the actual knowledge definition itself is relatively similar, the disclosure concept goes far beyond the disclosure schedules we are used to seeing in the U.S. and expands to documents made available in the data room and the UK typical vendor due diligence reports. In addition, U.S. policies generally provide for several coverage enhancements that are not widely, if at all, seen in UK policies. When having the choice – and the necessary financial means – we encourage insureds to obtain U.S.-style R&WI policies.

While being able to utilize R&WI might have been a competitive advantage a few years ago, today the paradigm has shifted. Understanding R&WI policies and market developments – on both a general and granular level – is a prerequisite for deal professionals and their advisors.

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