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Reps And Warranties Insurance Boom Reshaping PE Deals

By **Tom Zanki**

Law360, New York (August 24, 2015, 1:15 PM ET) -- More buyers of private equity assets are embracing representations and warranties insurance to stand out in crowded auctions where sellers demand enhanced bids, marking the growth of a product that experts say is increasingly deemed a prerequisite toward sealing middle-market deals.

A midyear study by Dechert LLP and insurance broker Marsh said issued R&W policies are projected to grow 20 to 30 percent from 2014 levels of more than 700, which was twice 2013 levels and quadruple the amount issued in 2012. Deals pros say the policies are gaining traction as they mature, often bought by the buyer at the seller's behest.

“You could have used it a few years ago as a buyer as a way for you to distinguish your bid,” said Dechert partner Mark Thierfelder, who chairs the firm’s global private equity practice and corporate and securities group. "Now, I think you'll find, at least in a competitive middle-market auction where the seller is a financial sponsor, if you don't use this product, you’ll be at a competitive disadvantage.”

The policies intend to bridge a gap between sellers, who want to limit their exposure as much as possible upon exits, and buyers, who want broad coverage for liabilities that can arise after closing. That can include claims as varied as misrepresentation of stock ownership, financial misstatements, pending litigation, and environmental and tax liabilities.

R&W policies originated in the late 1990s but are now finding more receptive buyers as policies become more standardized and premiums fall in price, while robust mergers and acquisitions activity widens the pool of insurable transactions.

Experts say the booming popularity of representations and warranties insurance has largely benefited sellers, who traditionally would set aside a portion of deal proceeds in escrow for a year or two to satisfy potential indemnification obligations for breaches of representations and warranties in an M&A deal. Instead of tying up capital, those sellers can now reap full proceeds of deals more quickly while subjecting themselves to less liability, experts say.

“Buyers are able to take sellers off the hook,” said Gibson Dunn partner Steven Shoemate, who is also a co-chair of the firm’s private equity practice group. “Sellers like that.”

For their part, buyers appear more inclined to embrace the tool as it gains credibility, overcoming initial skepticism over whether claims would actually pay out. Experts say those concerns appear to be

diminishing now that R&W policies have begun to build a track record.

“I think insurers have recognized that if they rejected claims that had merit, word would get around pretty quickly,” Shoemate said. “That would be like killing the golden goose.”

Either side can purchase an R&W policy, though the Dechert and Marsh report notes that more than 80 percent issued in 2014 were buy-side policies. Shoemate said one appeal to buyers is that, if a claim does arise, they can pursue it directly from the insurer instead of suing private equity firms.

Dechert and Marsh said coverage limits often top out around $350 million, mostly limited by the availability of underwriting capacity, with buyers typically paying premiums of 3 to 4 percent of the coverage limit. The policies cover the insured’s losses after a deductible, also called a retention amount, that is generally about 1.5 to 2 percent of the total deal value.

R&W policies are most common in middle-market transactions, as insurers are loath to cover small deals. Although policies vary according to industries and transaction-specific issues, experts say coverage has become more standardized as the market has matured, winning acceptance from buyers and sellers.

“Coverage has moved from a policy that had gaps and was not very tight in the old days to now, where it’s not quite a traditional indemnification package, but it mirrors it, tracks it a lot closer,” Dechert partner Markus Bolsinger said.

Pillsbury Winthrop Shaw Pittman LLP managing partner Jeffrey Grill says many insurance brokers have hired experienced M&A lawyers from large law firms to help develop and advise their clients on R&W policies, making the process more workable.

“The product is set up around the agreement, rather than the agreement around the product,” Grill said. “One of the things that makes it attractive is that it doesn’t change the way buyers and sellers would negotiate the transaction.”

Despite the booming popularity, R&W policies face limits in their growth. For one, many insurers are unwilling to cover high-risk industries. These include health care industries that are heavily dependent on Medicare or Medicaid reimbursements as well environmentally sensitive industries that involve controversial procedures like fracking.

Grill says further growth also depends on education. He noted that insurance brokers and deals lawyers are well acquainted with R&W policies, but he said industry clients are still learning the ropes, often seeking advice from those very insurers and lawyers before they consider taking out such a policy.

“Two years from now, acquisitive clients in the midmarket range will have a much greater understanding of this product,” Grill said.

Bolsinger said awareness is "snowballing" compared with just a few years ago.

“I think word is getting out," Bolsinger said. "Brokers are doing a good job making the newest trends available to first-time buyers. People are catching up, but there is still some discrepancy in sophistication.”

--Editing by Jeremy Barker and Mark Lebetkin.