

GOODWIN INSIGHTS

For Private Equity and M&A

M&A TRENDS: REPRESENTATIONS AND WARRANTIES INSURANCE

Historically, the use of representations and warranties insurance (“RWI”) in the United States was limited, although RWI has been around for about twenty years. RWI policies had high premiums and retention amounts with broad exclusions, required long lead time by the insurers to complete their due diligence and underwriting processes and came with a general uncertainty as to whether insurers would actually pay out on claims.

Over the last several years, the RWI market has evolved dramatically, and the process has become more efficient. The number of insurers jumped from a handful to over 20 today.¹ The increased competition has led to better pricing and an opportunity for the buyer to negotiate coverage enhancements, if they know what to ask for, particularly at the quote stage. Perhaps, most importantly, RWI has become more widely-accepted, both by private equity and corporate buyers, as a viable alternative to contractual indemnity as insurers have created a track record of having paid out claims.

The increased viability of RWI has had numerous benefits to the transaction execution process. For sellers, it provides a “clean” exit by limiting their post-closing indemnification exposure both in terms of the dollar amounts and duration. For buyers, offering it can be a distinguishing factor in a bid; although increasingly, buyers need to use RWI just to keep up with the competition and/or as the price of admission in an auction. Buyers can also obtain enhanced survival and coverage through RWI that might not ordinarily be available (e.g., a longer survival for general reps and read outs of materiality and damages exclusions). RWI can also speed up the negotiation process as there will be less negotiation on representations and warranties and certain other contentious provisions.

Goodwin has deep expertise in the use of RWI in a wide range of transactions, including “no indemnity” deals (as discussed below), healthcare deals, minority investments, secondary transactions, acquisitions of unaudited or distressed targets, sell-side policies, and cross-border deals insured by non-U.S. insurers. Goodwin surveyed its over 75 private equity and insurance coverage partners as well as our insurance industry contacts² to provide this update on current trends regarding RWI in the United States.

¹ In this article, references to insurers include managing general underwriters (MGUs) who write policies on behalf of participating insurers.

² This survey includes some input from brokers (Aon, JLT, Krauter, Lockton, Marsh, Willis) and insurers (AIG, Ambridge, Beazley, BlueChip, Concord, ETHOS, Euclid, Everest Insurance®, QBE, VALE). The views expressed here are the authors’ opinions and observations and should not be attributed to any sources.

TRANSACTION SIZE

Due to increased capacity, the market's reach is extending in both directions to include small deals below \$100 million (including add-ons) and large deals above \$1 billion. On transactions with enterprise value of \$50 million or less, an insurer's appetite will vary, and RWI can be harder to obtain, particularly if the target company is not audited. Some insurers view smaller policies as a risk diversification tool against larger policies they write, while some see greater risk with smaller deals and unsophisticated targets. Goodwin has successfully guided clients in securing RWI and minimizing exclusions for deals involving unaudited targets.

COSTS OF A RWI POLICY

The cost of RWI policies has improved significantly. Just a few years ago, premiums would often range from 3% to 4% of coverage limits for a policy with a higher retention ranging from 1.5% to 2% of the transaction value. Today, it is much more typical to see premiums around or below 3% of coverage limits with a retention of 1% of deal value. Premiums depend on a variety of risk factors that insurers consider, such as the target's industry and the parties involved, so we sometimes see the same insurer offering 2.5% in one deal, but 3.1% in another deal in the same week. We have also seen lower premiums if the policy will only cover a limited set of representations (e.g., fundamental representations, intellectual property representations).

The one caveat is that if the sellers provide no indemnity for breaches of representations and warranties in the purchase agreement, insurers typically require a slightly higher premium and/or a slightly higher retention to help guard themselves against the potentially higher risk caused by, and moral hazard of, sellers having little incentive to ensure the accuracy of their representations and warranties (and related disclosures).

In large transactions (typically, requiring \$30 million or more in coverage), building a tower of multiple insurers usually results in cost-savings. Typically, the premium charged by an excess insurer is discounted from the layer below because the higher the "attachment point," the less risky it is to insure, resulting in a reduced, blended rate for the buyer.

The typical underwriting fee is between \$25,000 and \$50,000, depending in part on whether the insurer conducts diligence in-house (few insurers) or engages outside counsel (almost all). When a tower of multiple insurers is used, each excess insurer typically charges \$5,000 because excess insurers rely on the work done by the primary insurer and its counsel to avoid duplication of efforts.

The premium is subject to state tax, with the rate being dependent on the address of the policyholder (e.g., approximately 4% in New York). Some states charge a modest amount of additional fees.

Broker fee can be another category of cost. All brokers receive a portion of the premium as their commission (usually 15%), but some broker fee structures are based on the policy limit purchased and could result in additional cost (offset by the commission paid out of the premium).

It is still uncommon to commence underwriting pre-exclusivity. In those cases, if the buyer chooses to begin the underwriting process pre-exclusivity, insurers charge a significant "pre-exclusivity" fee to do so. This fee used to be around a few hundred thousand dollars or more, but the rate and payment terms have become more negotiable.

RETENTION

In most cases, the lowest initial retention is 1% of the enterprise value. In large transactions (e.g., around \$1 billion) where the dollar amount of the retention is extremely high or in limited circumstances when a deal is deemed particularly attractive, the retention is sometimes set below 1% (e.g., 0.75%). It is common for the initial retention to drop down to 0.5% when the escrow breaks, although insurers sometimes offer a drop down sooner (e.g., 12 months) than the escrow break date (e.g., 18 months). In deals that do not have any seller escrow, insurers are also more willing to negotiate a similar drop down.

There are also a number of ways to structure the retention in any given deal. Goodwin has successfully negotiated more beneficial retention terms beyond those initially offered by insurers.

EXPANDED COVERAGE AND COVERAGE ISSUES

Typical Coverage Size

Buyers typically purchase coverage equal to approximately 10% of the deal value for a buy-side policy. In some cases, we have observed a higher policy limit (e.g., 20%) when the underlying contractual indemnity was deemed insufficient for a particular transaction, or a lower policy limit (e.g., 5%) when the target has been professionalized by a financial sponsor and the risk profile was deemed limited. In smaller transactions, the policy limit may need to be higher than 10% due to the minimum premium/retention that insurers require. For example, some insurers are willing to write a \$3 million policy (or even a \$1 million policy), but \$5 million is generally seen as the low end of the policy limit spectrum where it makes economic sense to the buyer.

While a buy-side policy is used to supplement the contractual indemnity, the determination is different for a sell-side policy. A sell-side policy is used to backstop the sellers' indemnity obligations, so the policy limit is determined by, and not larger than, the contractual indemnity.

Scope of Covered Issues

We have also observed that increased competition has led to insurers scaling back the number of exclusions voluntarily (notably at the quote stage) and created an opportunity for the savvy buyer to successfully work with insurers to avoid or narrow exclusions.

Exclusions

We note that the list and scope of standard policy exclusions have shrunk, but are relatively uniform across different insurers these days: covenant breaches, known breaches, "interim breaches" (new breaches arising and discovered between signing and closing), purchase price adjustments (and other payment obligations under the purchase agreement such as specific indemnities), pension underfunding liabilities, and certain tax matters (e.g., transfer taxes, net operating losses, other types of deferred tax assets and known tax liabilities (reserved/accrued on financial statements or disclosed in the disclosure schedules)).

We have observed deal-specific exclusions, if any, to generally originate from three sources: (i) industry-specific risks that an insurer has no appetite to cover (e.g., product warranty and bodily injury); (ii) deficiencies identified in diligence, especially those negotiated between the parties (e.g., sales and use tax liability); and (iii) topics that the insurer perceives as insufficiently diligenced (e.g., local law compliance where the target has sizeable operations in a particular foreign jurisdiction). Typically, the quotes reveal only the first type of exclusions, requiring the buyer to reserve the right to request a specific indemnity in the purchase agreement for additional exclusions that may come up as a result of the insurer's diligence.

Given the competitive pressure, insurers have become more willing to reconsider exclusions in each of these areas. For example, misclassification/wage and hour was often flagged as an exclusion by insurers at the quote stage, but it is more sparingly noted as an area of concern that insurers will review, particularly where the target has many hourly employees in California. More insurers are now covering healthcare deals, including those involving Medicare/Medicaid reimbursement, and, while negotiation around anti-kickback and similar issues can be difficult, we have obtained many policies without major coverage gaps. We have also observed that more insurers are willing to limit potential exclusions and provide coverage in excess of the coverage provided by primary insurance policies such as cyber insurance policy, where the buyer can show that such primary insurance is reasonably adequate. This approach, however, does not always work and insurers remain reluctant to cover medical malpractice-related risks, regardless of any underlying medical malpractice insurance.

While some deal-specific exclusions may be unavoidable (e.g., large tax issues identified in diligence), Goodwin has been successful in challenging exclusions as much as possible and articulating grounds to have exclusions removed or narrowed.

For buyers, it is important to review the exclusions carefully and, for known liabilities and risks, seek a specific indemnity, a reduction in purchase price or some other contractual protection outside of the RWI policy. In some cases, we have seen clients purchase a separate insurance policy to cover specific risks (e.g., known environmental liabilities).

Pre-Closing Taxes

Where the purchase agreement contains a stand-alone pre-closing tax indemnity, adding pre-closing tax indemnity coverage to RWI has become standard, in addition to coverage for breaches of the tax representations. That said, the pre-closing tax indemnity coverage under RWI is not necessarily broader than well-negotiated tax representations coverage. Under RWI, the pre-closing tax coverage only extends to taxes that buyer does not know about when the policy is bound. Policies expressly exclude accrued taxes that are not yet payable, even though such taxes would be covered under a standard seller indemnity. Further, pre-closing tax indemnity coverage under RWI is subject to the policy's retention and not on a first-dollar basis.

While a few do, U.S. insurers generally do not offer "synthetic" pre-closing tax indemnity where the purchase agreement does not contain such indemnity. Even when such indemnity is added, the scope may be narrower than a well-negotiated pre-closing tax indemnity and may not be a meaningful enhancement over the tax representations coverage in any event.

As a result, a stand-alone pre-closing tax indemnity from sellers continues to be a pre-requisite of, and cannot be fully replaced by, the pre-closing tax indemnity coverage in RWI. We see the practical value of having pre-closing tax indemnity coverage in RWI as a mechanism for obtaining a credit against the policy's retention, to the extent the buyer recovers from the seller through the contractual pre-closing tax indemnity (rather than via a breach of a tax representation claim).

Covered Losses and Materiality Scrape

In the past, consequential and multiple damages were excluded in the policy. It has become standard for policies to be silent as to their availability and give the buyer an opportunity to seek such damages, provided that the purchase agreement is also silent as to their availability. As a result, when RWI is used, the definition of losses is one of the key negotiation points. Where the buyer desires to negotiate an affirmative grant of consequential and multiple damages in the purchase agreement, we have successfully worked with some insurers to find a mutually acceptable solution.

Materiality scrapes are another negotiation point, as the policy will follow the purchase agreement. Typically, a double scrape of materiality (i.e., disregarding materiality qualifiers for purposes of determining if a breach has occurred and the scope of the damages) is negotiated in the purchase agreement when RWI is used. In this case, however, the sellers often ask for a "de minimis claims threshold" (i.e., a smaller threshold designed to thwart nuisance claims). Depending on how the retention is structured in the policy, such mini-basket may be followed or disregarded in the policy. If the retention is structured as 0.5% plus the basket where applicable, as discussed above, the mini-basket will also apply in the policy. If the retention is set as 1%, instead, the mini-basket and the basket will count toward the retention.

Recourse for Liabilities in Excess of the Coverage Limits

All RWI policies have a coverage limit. Certain covered losses, however, could generate losses in excess of the coverage limit. A buyer should determine whether to require sellers to indemnify buyer for these issues in excess of the RWI policy coverage. A buyer should also consider an escrow or similar form of guaranteed recourse in such situations and build in appropriate language, both in the policy and the agreement, as to the priority of payments.

"NO INDEMNITY" DEALS

Historically, RWI insurers have required both the buyer and sellers to have some skin in the game so that coverage would be limited to well-negotiated set of representations and warranties. Usually, the retention has been "split" between the buyer and sellers, with the buyer taking the first portion (typically 50%) of the retention as a non-tipping basket in the purchase agreement and the sellers indemnifying the buyer for the remainder of the retention, typically through an escrow funded from sellers' purchase price proceeds. Note that the retention is only eroded by "covered loss" under the policy. For example, if a payment is made from the escrow for a breach of a covenant or a matter excluded by the policy, such dollars do not count toward the retention, potentially resulting in a gap (to be filled by the buyer in most cases).

Goodwin has seen an increase in deals using RWI as the buyer's sole remedy, particularly in transactions with deal values in excess of \$200M. In such structure, the representations and warranties in the agreement will not survive the closing and the sellers have no indemnity liability for any breach. In other words, the buyer bears the full responsibility for the retention and look solely to the insurer to recover losses.

Just a few years ago, insurers had limited appetite to cover such deals, but they have become more mainstream. Most insurers quote a no seller indemnity structure as an option today, either routinely or selectively. In terms of the actual use of such structure, brokers and insurers have noted varying degrees of frequency, many pegging it around 20%, while some saw it as much as 50% or more. One explanation for such disparity is that the frequency of such deals is correlated with a higher enterprise value.

Given the increasingly competitive landscape, many insurers are offering the same terms in a no indemnity deal with only a modest increase in premium and/or the retention to reflect the increased risk and moral hazard issue of a no-seller indemnity structure. Building in a materiality scrape in a no indemnity deal used to be a challenge, but it has become more common to incorporate a double scrape, provided insurers can get comfortable that sellers have taken its disclosure obligation seriously and disclosed without regard to materiality. As a result, it is important for the parties to consider alternatives to materiality qualifiers in certain representations. For example, instead of disclosing the material contracts, customers and suppliers, it would be preferable to have a dollar threshold defining sellers' disclosure obligations.

In a no indemnity transaction, sellers may be amenable to providing a more fulsome set of representations and warranties (and not insist on making them seller-friendly, for example, by excessive use of knowledge-qualifiers) to not undermine the buyer's chances of recovery under the policy. Note, however, that insurers expect the representations and warranties to be negotiated at arm's length and limited to those that sellers can reasonably give,

qualified by appropriate disclosures. As a result, in any type of deal, insurers sometimes require the insertion of knowledge qualifiers or other line edits for policy purposes if they consider any representation and warranty to be overly buyer-friendly.

Another advantage of a no indemnity deal is that, in situations where on-going management were also sellers, the buyer does not have to make an indemnity claim against them.³ Also, in situations where a seller indemnity escrow could not otherwise be obtained, the buyer does not have to assume that credit risk.

One key disadvantage to a no indemnity deal for a buyer is that the sellers do not typically provide a stand-alone indemnity for damages in excess of the RWI policy (e.g., for fundamental representation breaches and the pre-closing tax indemnity), for pre-closing taxes, or for matters excluded by the policy.

CLAIMS

While industry-wide statistics are not readily available and the policies issued in recent years are still open, there has been increased reporting of significant (e.g., seven-figure) claim payments by different insurers. The frequency of claims has been increasing over the last several years, although many claims fall below the policy's retention and result in no payment. According to AIG who publishes its claims data, the most typical claims made globally related to financial statements (approximately 20%), compliance with laws (approximately 15%), material contracts (approximately 14%)⁴ and tax (approximately 14%). Industry-wide, financial statements-related breaches discovered in connection with the first audit are mentioned by insurers as the most typical type of claim. In terms of timing of claims, worldwide, approximately 27% of claims were made within 6 months of closing, 51% within 12 months of closing and approximately 76% within 18 months of closing.⁵ Goodwin assists clients in evaluating the carriers' claim-handling experience and reputation, in addition to the other factors, to help select an insurer.

³ A significant level of seller rollover could lead to certain coverage other limitations in the policy.

⁴ AIG's Global M&A Claims Study 2017 ("AIG 2017 Claim Study"): <https://www.aig.com/content/dam/aig/america-canada/us/documents/insights/aig-manda-claims-intelligence-r-and-w.pdf>

⁵ AIG 2017 Claim Study.

CONCLUSION

The RWI market has continued to evolve. We have seen significant changes even in the last six to twelve months and expect further changes to come. There are various strategic considerations for both the policy and the purchase agreement to maximize the buyer's remedies, and each transaction raises unique issues. It is important for the buyer to navigate the RWI process and negotiate coverage enhancements effectively, especially at the quote stage.

ABOUT GOODWIN

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