

CORPORATE INSURANCE LAW

Expert Analysis

R&W Insurance and Public Company Transactions

When first introduced, Representations and Warranties Insurance (RWI) proved attractive to parties to private Merger & Acquisition (M&A) transactions primarily because it allowed sellers to reduce their exposure to post-closing indemnity obligations arising from breaches of representations and warranties by transferring some of the risk to the insurer. As the use of RWI has increased over the past decade, it has become more common for RWI to be used either as a complete substitute for a seller indemnity for breaches of representations and warranties (in the absence of seller fraud) or for the seller to retain only a nominal indemnity obligation capped at an amount equivalent to all or a portion of the retention under the RWI policy (typically .75%-1% of enterprise value, in the aggregate, for domestic transactions).

Transactions in which the representations and warranties do not survive

HOWARD B. EPSTEIN is of counsel at Schulte Roth & Zabel, and THEODORE A. KEYES is special counsel at the firm. JEFF BUZEN, a partner at McGill and Partners, assisted in the preparation of this column.



By
**Howard B.
Epstein**



And
**Theodore A.
Keyes**

closing and sellers retain no indemnity risk are often referred to as “public-style” transactions—because, in part due to their disparate shareholder base, public companies do not typically provide indemnities to purchasers. Insurers’ willingness to issue RWI policies in connection with public-style private M&A transactions is one of the factors that have spurred growth in the RWI market—and the market has skyrocketed in recent years. According to a recent American Bar Association (ABA) study, from 2020 through the first quarter of 2021, 65% of private M&A transaction agreements explicitly referred to RWI, up from 52% during the period from 2018-2019 and 29% during the period from 2016-2017. See *ABA Private Target Mergers & Acquisitions Deal Points Study* (2021).

Historically, due to the lack of a seller indemnity, public company

purchasers needed to get comfortable self-insuring loss arising from breaches of the target’s representations and warranties. This is no longer the case because, as it has evolved, RWI has become increasingly available for public company transactions to mitigate risk associated with a public target’s breach of representations and warranties. For this column, we have collaborated with our colleagues at McGill and Partners to discuss the use of RWI in public company deals.

Why Use RWI on Public Deals?

Although public company M&A transactions have historically been structured as no-indemnity deals, RWI is nonetheless a valuable risk mitigation tool for public company purchasers.

Potential purchasers do typically have access to significantly more publicly available information on public targets than they do on private company targets, largely due to SEC disclosure requirements, but that does not eliminate the risk of post-closing loss tied to breaches of representations and warranties in public company deals. In fact, with some exceptions,

similar risks regarding the subject matter of representations and warranties (e.g., financial statements, material contracts, compliance with law, tax, intellectual property, cybersecurity, employment and environmental, among others) are present in connection with both private and public company transactions.

Further, many large breach claims relate not to known and undisclosed matters, but rather arise from unknown issues that were not discovered by the purchaser, management or the sellers until post-closing. Historically, a public company purchaser would have had no recourse to recovery with respect to such claims, but RWI provides a way to mitigate such risks in connection with public company transactions.

State of the Public M&A Market

Transactions involving publicly-traded companies take on a variety of forms, from take-private transactions, when an investor—whether they are a private equity firm, a high-net worth individual or a private company—acquires the public company, to a public company acquiring another public company. Whatever their form, these public M&A transactions are on the rise.

In 2021, 47 take-privates were announced, up from 33 in 2020 and the highest total since 2010. In 2022, through May 9th, there were 26 such deals announced, up from 17 during the same period last year. Jennifer Williams-Alvarez, *With Capital Levels High and Stocks Low, Going-Private Deals Rise*, Wall Street Journal (May 11, 2022).

There are two main factors contributing to the spike in public company transactions. The first is the sheer amount of capital available to complete M&A transactions. Un-deployed capital (or dry powder) for private equity firms has reportedly grown nearly 17% annually since 2015, reaching a new record of \$1.81 trillion in January 2022. Maera Tezuka and Madeleine Farman, *Another PE dry powder record set; VC rounds in US fintech surged in 2021*, S&P Global (Feb. 11, 2022). Likewise, despite certain challenges to the broader economy, large public corporations continue to retain sizeable cash reserves that can be used

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for M&A transactions. As of February 2022, the companies comprising the S&P 500 reportedly held \$2.7 trillion in cash. Matt Krantz, *13 Firms Hoard \$1 Trillion in Cash (We're Looking At You Big Tech)*, Investor's Business Daily (Feb. 3, 2022). Moreover, in a recent survey of 281 executives, a whopping 80% noted that M&A is part of their business strategy. David Harding et al., *State of the M&A Market*, Bain & Company (Feb. 8, 2022).

The second factor contributing to heightened public M&A activity is precarious stock prices. Typically, the acquirer of a public company will need to pay a premium over recent market prices in order to strike a deal

with the company's board of directors. When there is downward pressure and volatility impacting stock prices, as is the case now, the valuations for public company M&A transactions become far more palatable. Consequently, depending in part on how stocks perform throughout the rest of 2022 and into 2023, public companies may continue to be attractive M&A targets.

The Growing RWI Market For Public Deals

As of June 2022, there were 24 primary RWI underwriters in the United States' domestic market, with at least another three expected to enter the market by the end of the year. Each of these underwriters has different risk appetites. Some, for example, will not underwrite target companies that operate in more regulated sectors, such as healthcare or financial services. Others may not be willing to underwrite target companies with significant operations outside of the United States. For some underwriters, public company M&A transactions are simply outside of their business plan. However, many of the more-established insurers that tend to focus on upper-middle-market (and larger) transactions will underwrite public M&A transactions, so long as they are comfortable with the operational risks associated with the business.

Currently, although RWI is available for public company transactions, anecdotal evidence suggests that most public M&A deal participants do not utilize RWI. The main drag on demand for RWI in public company transactions may be a lack of understanding that RWI is available

and can provide the acquirer with comparable protection to that which is available in connection with a private M&A transaction. In those public transactions where an RWI policy is purchased, it is typically because the purchaser and/or their advisors have experience with RWI in private M&A transactions and are looking to obtain similar protection and risk mitigation in connection with a public company acquisition.

Comparison of Coverage Terms: Private vs. Public

Whether the target company is public or private, the economics of placing the RWI policy are likely to be fairly similar. Because there are fewer insurers willing to underwrite public M&A transactions (and therefore less competition) pricing may be slightly higher, but factors such as enterprise value, insurance limit and target operations will have a greater impact on the insurance premium and retention.

There are certain points to bear in mind to maximize RWI coverage on public company deals, as further detailed below, but coverage, in some circumstances, can be nearly as broad as in a private company deal. To get there, however, purchaser and purchaser's counsel will need to push for thorough disclosure schedules and demonstrate to the underwriters that they have conducted robust due diligence.

As an initial matter, changes may need to be made to the public M&A transaction agreement, disclosure exercise and due diligence process to obtain the broadest possible RWI

policy. A public M&A transaction agreement will normally include broad representations relating to the accuracy of the company's SEC filings and compliance with SEC disclosure requirements. These types of representations will not typically be covered under an RWI policy. Therefore, the purchaser will need to require the public company to include specific subject-matter representations, such as those that are routinely included in private M&A transaction agreements (e.g., litigation, compliance with laws, tax, environmental, intellectual property, employment, cybersecurity, material contracts), in the public M&A merger agreement.

Public M&A transaction agreements make frequent use of Material Adverse Effect (MAE) and materiality qualifiers in the representations and warranties. It is therefore imperative to include a synthetic materiality scrape in the RWI policy, whereby all references to MAE and materiality (and similar qualifiers) are deemed removed for purposes of determining whether a breach has occurred and quantifying the loss arising therefrom. To get comfortable offering a materiality scrape (without imposing a per-claim dollar threshold), RWI underwriters will be very focused on diligence and disclosure, so purchaser's counsel will need to conduct a thorough due diligence exercise, without relying on materiality thresholds, and insist that the company provide detailed disclosure schedules, irrespective of whether the representations and warranties are qualified by MAE or materiality.

If given the deal dynamics, it is not feasible to negotiate a robust set of representations and warranties, conduct comprehensive due diligence and have thorough disclosure schedules from the target company, RWI may not be a good fit. But when these goals are obtainable, RWI can serve as an effective risk mitigation tool just as it does in connection with private transactions.

Looking Forward

The final consideration transaction attorneys should bear in mind are the experience levels of the RWI insurance brokers and underwriters. In order to ensure an efficient RWI process and negotiation of a favorable RWI product for a public company deal, counsel are best served by teaming with insurance brokers and underwriters with experience and an understanding of (and comfort with) the differences between public M&A transactions and private M&A transactions and the associated RWI products.

Schulte Roth & Zabel

Schulte Roth & Zabel LLP
919 Third Avenue, New York, NY 10022
212.756.2000 tel | 212.593.5955 fax | www.srz.com
New York | Washington DC | London