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Expert Analysis

Representations and Warranty Insurance Comes of Age

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Representation and Warranties insurance was first introduced to the market place around 1998. Since that time, now closing in on two decades, the use of Rep and Warranties insurance has grown considerably, particularly over the last three years. While initially some may have viewed such transactional insurance as a novelty, these products are now routinely considered by deal practitioners as a strategic option to mitigate risks in connection with the purchase and sale of businesses.

We first discussed the emergence of Rep and Warranties insurance as a deal-making tool in our September 2012 column.[1] Over the last few years, however, Rep and Warranties insurance has become an increasingly important option as funds, banks and their counsel have grown more comfortable with these products. For example, AIG, one of the leading insurers in the market, reports that in 2015, AIG reviewed eight times more submissions for Rep and Warranties insurance as compared to 2012 and bound five times more policies than the number bound in 2012. This dramatic increase is consistent with anecdotal evidence reported by deal practitioners.

R&W Insurance 101

In general, an agreement governing the sale or acquisition of a business will call for the seller to indemnify the buyer for material breaches of representations and warranties. Rep and Warranties insurance protects the insured from loss, or at least mitigates loss, due to the breach of these representations and warranties.

Reps and Warranties insurance policies are sold either as buyer-side or seller-side policies. A buyer-side policy, which is more common, insures the buyer for loss due to a breach by the seller. In some transactions, the buyer-side policy may replace the seller's indemnity obligations. Other transactions will be structured so that the buyer-side policy provides coverage for loss in excess or in addition to the seller's obligations. A seller-side policy, on the other hand, insures the seller for loss incurred as a result of a breach of the seller's own representations and warranties.

> Rep and Warranties insurance products are now routinely considered by deal practitioners as a strategic option to mitigate risks in connection with the purchase and sale of businesses.

In typical negotiations, a seller may seek to have the buyer rely on a buyer-side policy in lieu of any seller indemnity obligations. If the buyer is unwilling, the seller may purchase a seller-side policy to cover or mitigate its own exposure to loss due to its indemnity obligations for breach of a representation or warranty. In some cases, a seller will be able to negotiate a Rep and Warranties policy that nearly mirrors its indemnity obligations under the purchase agreement, with the result that the seller's only potential exposure will be for the deductible or for loss in excess of the policy limits.

Many merger and acquisition transactions involve complicated seller indemnities that employ caps, thresholds and baskets, sometimes with accompanying escrow provisions to further allocate the risk between the seller and the buyer. These provisions are important to the insurer's review of a given transaction because they provide information concerning the shifting of the risk. Depending on the transaction, triggering of rights under the insurance policy may also be contingent on satisfaction of caps or thresholds in the acquisition agreement.

In any event, both buyer-side and seller-side policies will be subject to deductibles or retentions which need to be satisfied before any insurance recovery. Typically, a retention will be set at somewhere between 1 to 3 percent of the transaction value.

Growth Factors

Many factors appear to have contributed to the growth of the Rep and Warranties insurance market. Certainly, deal practitioners' increased familiarity with these insurance products is a key contributing factor. Further, over the years, the underwriting process has been streamlined and become an anticipated aspect of a transaction timeline.

Economic factors have likely also played a role in the increased demand. The current market is reportedly favorable to sellers with cash-rich buyers competing for attractive businesses. As a result, sellers are in position to offer more narrow indemnification terms, causing buyers to turn to Rep and Warranties insurance to mitigate their exposure to loss from a seller breach.

In addition, the traditional reasons that certain sellers were initially attracted to Rep and

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Warranties policies continue to make these products an effective option. For example, sellers, particularly investment funds, may prefer to limit both their indemnity exposure and the amount of sale proceeds that would otherwise be tied up in escrow accounts to cover holdback obligations. These investment funds may prefer to close out transactions, pay off related debt and make distributions to their investors. By acquiring a Rep and Warranties policy, the sellers can reduce or eliminate the need to hold back funds to cover their potential indemnity obligations.

In some cases, management of an acquired entity will continue to run the acquired business after closing. The same managers who were owners prior to the sale may continue to have some equity stake after the transaction. In other situations, the sellers may be a customer or supplier of the acquired business. In all of these circumstances, it may be awkward for the buyer to bring indemnification claims against the sellers. A Rep and Warranties policy can shift the majority of exposure for breaches to the insurer and allow buyers to recover without damaging possibly important business relationships.

Finally, market capacity has also increased over the last few years with more insurers entering and competing in the market place. Premiums for typical policies continue to range from 2 to 5 percent of the transaction value, but higher limits are now available with many insurers also willing to offer excess insurance to fill out a tower. In addition, while the United States and Canada remain the more active markets, Rep and Warranties insurance is now available in some foreign markets as well.

Underwriting Process

The underwriting process typically begins with the execution of a non-disclosure agreement and submission to the insurers of certain key documents, including a draft of the acquisition agreement and the relevant financial information. Within a short period of time, the insurer will issue a quote subject to due diligence requirements. In order to proceed, the insured than must pay an underwriting fee to the insurer. Following receipt of the fee, the insurer will commence more comprehensive due diligence which will include access to additional documents and information as well as communications with the deal team. Negotiations on policy terms will then follow before binding of coverage.

There are a number of important underwriting considerations, starting with the identity of the buyer, seller and their advisors and the type and location of the business that is the subject of the transaction. The underwriters will evaluate the transaction based primarily on the deal documents, other due diligence materials and their experience with the type of risk. Familiarity with the parties—the buyers, sellers and/or their advisors—through repeat business may also help the insurers get comfortable with a risk more quickly.

Depending on the transaction, the scope of exclusions to coverage may need to be negotiated. There may be specific representations or warranties that an insurer is not willing to cover. While this will vary to a degree from transaction to transaction, insurers will typically exclude certain environmental and product liability risks as well as other risks that should be covered by other existing insurance. In addition, Rep and Warranties policies will exclude coverage for breaches that were known to deal team members prior to inception of the policy or prior to execution of a no claims declaration.

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Claims Experience

Recently, AIG published a report providing information concerning claims experience under its Rep and Warranties policies.[2] The report tracks the frequency and subject matter of claims reported from 2011–2014 in the United States and globally. According to AIG, a claim was reported under approximately one in every seven policies issued globally. Transactions that were larger than $1 billion resulted in a claim 19 percent of the time, but smaller deals still resulted in claims at a rate of 13 percent to 15 percent. Claims were more likely to be reported under seller-side policies, but claims under buyer-side policies resulted in larger average losses.

Globally, the most commonly alleged claims involved breaches related to representations in financial statements. Other commonly alleged breaches concerned tax information and contracts. In the United States, a more varied range of breaches also included intellectual property, data and insurance-related representations.

As far as timing, more than half of all global claims were reported within a year after closing, and almost three-quarters were reported within 18 months. Nevertheless, approximately a quarter of all claims were reported more than 18 months after closing of the transaction.

Looking Forward

Each Rep and Warranties policy will vary to some degree based on the specific risks associated with the transaction. Negotiating your policy will likely require teamwork between your deal practitioners and insurance experts. However, if you start with a proven policy form, you are more likely to end up with a suitable final product.

The growing market and growing demand for Rep and Warranties insurance demonstrates that this product has become a valuable tool for deal makers which allows parties to a transaction to mitigate the risks associated with breaches of representations and warranties. The experience of the last few years suggests that use of these policies will continue to grow as more practitioners gain experience with the product.

1. Howard B. Epstein and Theodore A. Keyes, “Representations and Warranties Insurance as Deal Making Tool”, N.Y.L.J. Vol. 248, No. 59, September 24, 2012.

2. What Happens After a Deal Closes?: Representations and Warranties Insurance Global Claims Study (AIG 2016).

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