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Representations and Warranties Insurance in a Deal

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Special to the Legal


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Parties to corporate transactions are using representations and warranties insurance to help close deals. Sellers in a corporate deal are typically required to provide some contractual indemnity with respect to potential breaches of representations and warranties, often accompanied by an escrow of part of the purchase price. "Reps and warranties" insurance is used to reallocate the risk associated with breaches of representations and warranties and has quickly risen to become a standard topic of discussion in many corporate transaction negotiations. Although reps and warranties insurance has been available for over 15 years, its popularity has been on the rise over the past few years. Insurance brokers estimate that reps and warranties insurance policies with aggregate policy limits of $10 billion were issued in 2012, $15 billion in 2013, and nearing $40 billion in 2014.

What Is Reps and Warranties Insurance?

Reps and warranties insurance is an insurance product in which either the buyer or seller in an M&A transaction secures protection against breaches of the representations and warranties made by the target company or sellers in the purchase and sale or merger agreement. This product helps protect both buyers and sellers involved in the transaction against financial loss in the event inaccuracies in the seller's representations and warranties are discovered post-closing.

Reps and warranties insurance policies are closely tailored to the specific requirements of a purchase agreement. Unlike many other types of insurance products that use standard policy forms, reps and warranties insurance is often tailored to meet the needs of the parties to a deal or policyholder. Generally, reps and warranties insurance policies cover loss from claims made by the buyer for any breach of, or alleged inaccuracy in any of, the representations and warranties made by the seller in the purchase agreement. The definition of "loss" in the policy generally follows the extent of the indemnity negotiated in the purchase agreement.

Most policies are subject to a self-insured retention. The self-insured retention is generally determined based on the transaction value of the deal, with a standard retention ranging from 1 to 3 percent of the transaction value. For example, the retention for a $50 million deal will likely range from $500,000 to $1.5 million. However, the retention will vary from deal to deal based on the risk involved.

Sell-Side v. Buy-Side Policies

There are two main types of reps and warranties insurance policies that can be purchased in connection with a corporate transaction: a buy-side policy and a sell-side policy. A buy-side policy essentially provides first-party coverage, which allows the buyer to recover directly from the insurer for its losses due to a seller's breach of a representation or warranty, thereby eliminating, in most cases, the need to bring an action against the seller. A sell-side policy provides third-party liability coverage, which allows the seller to tender to its insurer a claim from the buyer or other party alleging that the seller breached a representation or warranty at the time of closing.

Acquiring Reps and Warranties Insurance

Reps and warranties insurance is priced as a percentage of the limits of coverage purchased. This pricing is based on a number of factors, including the nature of the risk involved, the extent of the due diligence performed by the parties, and the relative size of the deductible. Typically, a price range of 2 to 3.5 percent of the coverage limits is standard. Therefore, a $10 million reps and warranties policy on a standard deal might cost approximately $300,000. Who is responsible for paying this premium is generally a function of the deal and depends largely on who is benefiting most from the insurance. If there are many competitive bids, a buyer may choose to pay this premium to distinguish its bid from others. On the other hand, a seller may choose to pay this premium in order to avoid putting up an indemnity or holdback. Ultimately, the decision of whether to purchase reps and warranties insurance and, consequently, how to structure the deal lies with the parties to the deal.

Once the parties decide to purchase reps and warranties insurance, the carriers and brokers typically accommodate this need for insurance quickly. Generally, a broker can place its client with a carrier within 24 hours. Carriers known for servicing the reps and warranties insurance market will typically provide a price and coverage quote within two to three days and will likely request due diligence reports and access to the seller's data room. Within a week of reviewing the due diligence, the carrier typically issues a draft insurance policy. Reps and warranties insurers understand the time sensitivity of the transaction and can accommodate their insured accordingly.

Reps and warranties insurance should not be a substitute for proper due diligence. There may still be uninsured risk because reps and warranties insurance may not cover known breaches of reps and warranties. Further, insurance carriers will need to determine the best manner in which to provide a marketable product while also adding necessary exclusions to protect against the moral hazard inherent in shifting risk to another party.

Benefits

The real question for most parties to a transaction is what kinds of benefits reps and warranties insurance can provide. For many sellers, the answer is clear. Sellers want to limit their indemnity exposure and limit holdback or escrow obligations. In most cases, this product allows the seller to walk away scot-free without having to return part of the purchase price, even if the buyer brings a claim. Buyers are comforted by the ease of reimbursement to recover losses directly from an insurer rather than having to locate and pursue the seller and its assets. This is especially true where the buyer and the seller have an ongoing relationship and the buyer does not want to bring a claim against the seller.

Reps and warranties insurance has also transformed the manner in which a transaction can be structured. The availability of insurance allows both parties to a transaction flexibility to negotiate purchase price. For example, reps and warranties insurance may reduce or eliminate the need for escrows or purchase price holdbacks and indemnity retention limits, which facilitates the transaction and may allow the seller to distribute the funds from a transaction more quickly. This enables buyers to contribute more toward an increased purchase price, and gives sellers the ability to complete the deal at a lower purchase price, thus narrowing the gap in the parties' negotiating positions. Sellers are also resistant to escrows because they tie up funds for extensive periods of time. Reps and warranties insurance has also been particularly useful in resolving impasses in negotiations over whether a specific representation or warranty will be issued, the scope, duration, and limits of an indemnity, or the size of an indemnification escrow.

Increased Use

The M&A world in the last few years has been infiltrated with buyers, as many private equity funds and corporate buyers have seen an increase in cash flow, which has created a seller's market. Therefore, buyers have utilized reps and warranties insurance to enhance their bids in a competitive auction process. Given that sellers' expectations of buyers have been raised, it is becoming more common for sellers to require buyers to get prepriced reps and warranties insurance as part of their offering bids.

In addition, there is a continuing increase in middle-market deals ranging from $25 million to $2 billion—the sweet spot for reps and warranties insurance. As of June 30, the average deal value for the year was $137 million, according to Bank Street Partners. These types of middle-market transactions are perfectly sized to benefit from reps and warranties insurance. While reps and warranties insurance can theoretically be placed on deals below $25 million, the pricing on such deals may become prohibitively expensive due to minimum premium demands by many carriers and the costs for the carriers to undertake their own due diligence on the deal. Deals in the multibillion-dollar range may be unaffected by the amounts of limits currently available, and are less likely to rely on reps and warranties insurance. Reps and warranties carriers have been targeting these types of middle-market deals since its inception because of the meaningful impact on deals of that size, which helps explain the escalated use of reps and warranties insurance.

As the number of corporate transactions and mergers continues to increase, the use of reps and warranties insurance will continue to expand. It will be interesting to see if 2015 brings another year of significant growth in the reps and warranties insurance market. Reps and warranties insurance carriers are improving upon their ability to provide reps and warranties insurance in an economical and effective manner without delaying the deal, while also providing coverage for troublesome aspects of a transaction, which might otherwise thwart a deal's completion. •