

# Representations and Warranties Insurance: Seven Practical Considerations

by Eric B. Oxley, W. Grant Mullin and Michael J. Keblesh

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Representations and warranties insurance (“RWI”) is an increasingly popular way to allocate risk in merger and acquisitions (“M&A”) transactions by transferring it away from buyers and sellers to insurers, who agree to indemnify buyers for breaches of representations and warranties.<sup>1</sup> It is becoming an important component on many deals, and in some cases, a prerequisite for a transaction to be done at all. This article provides a practical guide to the RWI process to help buyers understand what to expect and how to get the best possible policy.

## 1. Why Use RWI?

RWI can add value in many types of transactions. It is especially helpful where the seller needs the ability to walk away following the transaction with a minimal amount at risk. For example, private equity sellers who are looking to close out a fund may not want to retain cash or tie it up in an escrow



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account for possible indemnity claims. In this scenario, including RWI in an auction draft or making it clear up front that it is a prerequisite for the deal allows the private equity seller to control the terms of its own exit, thereby minimizing their post-closing indemnity risk and allowing them to liquidate the applicable fund shortly after closing. Another useful application is where the seller is going to continue to own a significant portion of the business and/or be a key employee or officer after closing. In such cases, if there is a claim, RWI can help prevent strain on the relationship between the parties because the insurer will be responsible for most of the indemnification obligation. Even if there is no specific reason why the parties want to transfer the risk of indemnity claims to an insurer, the certainty that RWI can provide is valuable to many sellers.

### 2. Timeline Implications

It takes roughly two to three weeks to procure an RWI policy. That timeline can be compressed, but only if legal and financial due diligence have already been completed. Buyers in particular should expect an additional, and potentially significant, work stream leading up to signing. The following chart provides a rough timeline and outlines the steps involved in procuring a policy.

### 3. Finding the Right Advisors

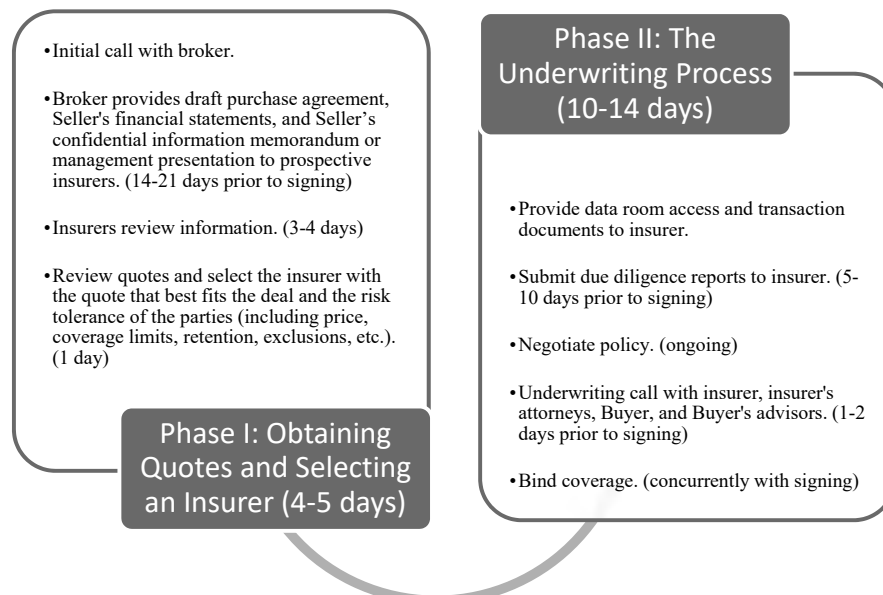
The RWI underwriting process can be difficult to navigate without the right advisors. A broker who specializes in RWI and who is familiar with M&A can add tremendous value by (1) helping structure the scope and amount of coverage best suited for the transaction and buyer's need; (2) obtaining and analyzing quotes; (3) helping select the right insurer and preparing for underwriting; (4) managing the underwriting process and assisting with policy negotiations; (5) providing insight on how par-

ticular insurers will respond on certain points; and (6) depending on the broker, providing claim assistance at no additional charge.

It's also important to have the right law firm supporting and advising you to get the best policy terms with the fewest possible coverage exclusions. The RWI underwriting process will drill down into various legal due diligence topics. Analyzing all of the issues involved and responding to the insurer in a way that will give the insurer comfort and minimize coverage exclusions requires a number of subject matter experts, which means that full-service law firms are better equipped to navigate the process than highly-specialized firms. Furthermore, it is important to have attorneys who are experienced with the RWI underwriting process, because they help drive the diligence process, review reports from other advisors to ensure they are clear and complete, prepare everyone—including clients, subject matter experts, and financial advisors—for the underwriting call, modify the transaction documents appropriately to conform with the RWI structure, and generally help clients avoid the common pitfalls mentioned below.

### 4. Impact on Diligence

Although RWI should not impact the level of scrutiny applied by a buyer's advisors during due diligence, RWI does affect the process. The primary impact of RWI on the diligence process is the need for Buyer's counsel and other advisors to prepare comprehensive due diligence reports covering all aspects of Seller's business. While audited financials are preferable, in certain instances insurers will proceed with unaudited financials. However, in those cases, a full-scale third party quality of earnings and a tax report are generally required. In addition, if real estate is involved, Phase I environmental inspections and, in some cases, environmental compliance reports will be required. These legal and financial due diligence reports form the basis



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of the underwriter's due diligence. If done properly, they can facilitate the underwriting process and minimize exclusions by demonstrating to the insurer that the review was thorough and that Buyer's advisors are competent and transparent. Ultimately the insurer conducts confirmatory due diligence based on the reports it is provided, and it is Buyer's responsibility to provide diligence supporting each representation and warranty to get the insurer comfortable with what they will be insuring.

The second thing to be aware of is the addition of the RWI underwriting call. This is a conference call with Buyer, all of Buyer's advisors (including the RWI broker), and the RWI underwriters (and their attorneys). This occurs shortly before signing once the underwriters have reviewed Buyer's diligence reports and conducted their own confirmatory diligence of the target. The call will follow an agenda provided by the insurer, which will contain a series of questions or topics related to the transaction and Buyer's diligence related thereto. In addition to probing specific areas of due diligence, the call allows underwriters to gauge the confidence and competence of Buyer and its advisors. Generally, underwriters already know what exclusions are going to be in the policy prior to the underwriting call. While the call will not remove these exclusions, it is certainly possible for additional exclusions to be generated if Buyer and its advisors are not prepared. Following the underwriting call, the insurer will produce follow-up questions and proposed exclusions (which typically arise because diligence was not

conducted in a certain area or because they relate to known issues), and Buyer can use the remaining time before signing to answer the follow-up questions and seek to limit or remove any proposed exclusions either by conducting more diligence or demonstrating that the risk is immaterial or unlikely to occur.

## 5. Impact on Negotiations

Some sellers are now signaling that RWI is a prerequisite for getting a transaction by including it in their auction drafts. In other cases, buyers can offer RWI as a way to increase the attractiveness of their offer relative to other potential buyers, or to close a negotiating gap to finalize a letter of intent. Using RWI can simplify purchase agreement negotiations and increase certainty of closing because it compartmentalizes the negotiations: the parties are free to negotiate business issues while Buyer and the insurer negotiate to allocate the risk. This takes some of the pressure off of the negotiations between Buyer and Seller related to indemnification provisions and representation and warranties, which can sometimes be major obstacles to getting a deal done. Negotiations about this type of risk allocation become more focused on items that are excluded from RWI coverage.

While negotiating with Seller may be more straightforward, negotiating with the RWI provider may not be. Because an insurer is taking the risk of Seller's breach of its representations



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and warranties, the insurer is now likely to negotiate for exclusions to the RWI Policy. Experienced legal counsel and an RWI broker who is well-versed in M&A are important resources during these negotiations because they can help explain the risks associated with a particular exclusion or qualification, identify which are important enough to negotiate, and help avoid wasting time negotiating points on which they know no insurer will concede. Some exclusions are standard to a particular industry or a particular RWI carrier. For instance, broadly speaking, RWI carriers won't insure PCB or asbestos risk, breaches for which a deal team member had prior actual knowledge, and forward-looking statements. Other deal-specific exclusions can arise if the insurer believes diligence has been insufficient in a certain area or related to an identified material risk.

It's also important to remember that RWI only provides coverage for unknown risks, so buyers shouldn't expect carriers to cover known risks identified in diligence or risks inherent in the nature of the particular deal. If risks are discovered, the parties will have to negotiate to allocate them. Depending on the relative bargaining position of Buyer and Seller, known risks might be borne by Buyer, or they might remain with Seller in the form of specific indemnities and a larger escrow.

### 6. Cost

Issuing RWI has proven to be profitable for insurers, and as a result, costs are falling and terms are becoming more favorable as competition increases among carriers. Premiums for RWI typically range from 2%-4% of the coverage limit purchased. Deductibles, which generally dictate the amount of purchase price that will be escrowed, used to range from 1.5% to 2% of transaction value, but newer market entrants have forced insurers to be more aggressive with deductibles at 1.25% or even 1% of transaction value. Other fees include underwriting fees (typically \$25,000 to \$45,000 per transaction), surplus lines taxes and RWI broker compensation.

The influx of capacity, increased carrier staffing, and maturation of the product all have helped to expand the reach of RWI to both the upper and lower ends of the M&A spectrum. In particular, carriers have reduced their minimum deductible and premium levels (on a dollars basis), thereby making RWI an economically viable solution for lower middle market deals. Historically, carriers were reluctant to quote policy limits of less than \$10 million and deductibles of less than \$750,000. Today, however, minimum policy size is as low as \$3 million and minimum deductibles are as low as \$300,000 (depending on the carrier).

Using RWI on a transaction also has the potential to impact other deal costs, particularly for Buyer. Negotiating the policy adds an additional and potentially significant work stream for Buyer's counsel, and producing a satisfactory due diligence report can be fairly costly. On the other hand, RWI can simplify purchase agreement negotiations and increase the


certainty of closing, which brings its own benefits.

Who pays for RWI coverage varies significantly and is based on the bargaining positions of the parties on a particular deal. Where Seller has a strong bargaining position, it is not unusual for buyers to pay the entire cost of the policy and the entire deductible in the event of a claim. For less competitive deals, the costs of the policy and the deductible are typically split between Buyer and Seller with a small escrow to cover Seller's portion of the deductible.

### 7. Common Pitfalls and Best Practices to Achieve the Best Outcome

The primary best practice that will allow you to maximize the benefit of RWI is to complete a thorough diligence process and submit comprehensive reports to the insurer. Being transparent and viewing the insurer as a partner typically leads to better policies being issued because the insurers are able to gain comfort that they are aware of all of the known risks on the deal.

The diligence process typically culminates with a due diligence or underwriting call where the underwriters ask a series of questions of Buyer's attorneys and specialists who performed diligence on Seller. The best way to prepare for this call is to request the agenda from the insurer a day or two early and conduct a practice call led by Buyer's counsel, with Buyer and all of its advisors participating. This will help identify holes in diligence so they can be resolved prior to the actual underwriting call. Inevitably, the underwriters will ask questions that the diligence team is not prepared to answer. The best way to handle that situation is to answer honestly and tell the underwriter that you will find an answer and follow up after the call.

One of the most common pitfalls occurs when Buyer or its advisors take an adversarial tone with the insurer. This may lead to increased scrutiny on the part of the insurer, which may generate additional exclusions in the policy. Another common pitfall that can lead to exclusions occurs when the insurer asks a difficult question on the underwriting call. If Buyer or its advisors responds by saying "we didn't look at that" or "we don't view that as a risk," then that may create additional exclusions. The better approach to avoid unnecessary exclusions is to let the insurer know that you don't know at present, but that you will conduct additional diligence and follow up after the call. 

*Special thanks to Josh Halpern at Aon Risk Solutions for his helpful insights, which were instrumental in the preparation of this article. Josh is an RWI Broker with extensive M&A experience.*

### Endnote

- <sup>1</sup> For a more in-depth explanation of what RWI is, see Teresa A. Beaufait & Anshu S. K. Pasricha, *Nuts and Bolts of Representations and Warranties Insurance*, TODAY'S GENERAL COUNSEL, Jun/Jul 2015, at 46-47, 51.