KIRKLAND & ELLIS

Why You Need M&A Reps and Warranties Insurance

—By Hamed Meshki and Brandon Vongsawad, Kirkland & Ellis LLP

Critical to a buyer's and seller's evaluation of the acquisition and sale of a company is the allocation of exposure between them with respect to unknown risks and liabilities of the business. Representation and warranty insurance (RWI) protects the insured against unintentional and unknown breaches of a seller's representations and warranties made in the acquisition or merger agreement. It can extend or back-stop an indemnification package or serve as the buyer's sole source of recovery.

Deal makers have tested RWI in various contexts since the product's introduction to the market over 15 years ago and are purchasing policies with increasing frequency. In many cases, deal makers turn to RWI reactively, only after negotiations appear to result in suboptimal exposure to business risks, whether as a result of the scope (or absence) of an indemnification package or the creditworthiness of indemnitors (and in some cases, co-indemnitors).

When employed early, however, RWI may also increase deal value and may make the difference between whether or not a deal gets done.

Buy-Side vs. Sell-Side Policies

RWI policies generally cover either buyers (a "buy-side" policy) or sellers (a "sell-side" policy), although circumstances may incentivize sellers to purchase a buy-side policy on behalf of a buyer or vice versa. Careful thought should be given to whether RWI is appropriate for a particular deal and, if so, whether to purchase a buy-side policy or a sell-side policy.

Both buy-side and sell-side policies can preserve deal value by shifting potential liability for unintentional and unknown breaches of representations and warranties to insurers for a fixed cost. In addition, despite what its name may suggest, RWI may also be available to cover certain general indemnities beyond the actual representations and warranties.

In exchange for a fixed upfront payment to cover the premium and related expenses, a policy may reduce or eliminate the need for seller accruals, reserves or collateral for contingent liabilities. Particularly in the recent low-interest rate environment in which escrowed and holdback funds have been deposited, cost of capital considerations have continued to move principals in the direction of RWI policies.

Buy-side policies make up the majority of RWI policies underwritten in the United States. Because they allow a buyer to recover directly from the insurer without making a claim against the sellers, these policies have the potential to reduce, or even eliminate, a buyer's reliance on the sellers' funding of indemnification payments in respect of breaches of representations and warranties.

From a buyer's perspective, this may avoid the complex dynamics of seeking indemnification recoveries from "friendly indemnitors" such as management and other institutional investors with whom the buyer may have continuing or other business relationships. Similarly, the ability to recover directly from an insurer may reduce or eliminate distraction to management and disruption of the company's normal business operations that may otherwise result from an indemnity claim. It can provide a source of recovery where an indemnity would not otherwise be available (e.g., in the context of a public company acquisition), and it may also reduce collection risk where there are numerous sellers, foreign sellers or sellers at risk of insolvency. To be sure, depending on the facts and circumstances of the transaction, deal makers may also address these issues to some extent with a combination of other tools in a deal maker's toolbox, including escrows, holdbacks and provisions allocating seller liability — principals should consider the totality of the deal dynamics when structuring the appropriate package of breach remedies.

THE AUTHORS

Hamed Meshki
Partner
Los Angeles

hamed.meshki@kirkland.com
+1 213-680-8360

Brandon Vongsawad
Associate
Los Angeles

brandon.vongsawad@kirkland.com
+1 213-680-8319

Attorney Advertising

From a seller's perspective, this may eliminate the need to establish purchase price escrows or holdbacks for the buyer's benefit. Where the seller is an investment fund or holding company, this allows the seller to distribute greater portions of the purchase price to its investors while reducing the prospects and risk of clawback. This "clean exit" can be particularly attractive for funds in their holding periods and sellers whose investors are focused on initial rate of return and similar performance metrics.

Because of these benefits to sellers, a buyer's willingness to look to a buy-side policy in lieu of seller indemnity (or even in combination with a lesser indemnity) can differentiate its bid in a competitive process. And conversely, sellers in that context may be willing to provide generally more fulsome representation and warranty coverage, both in scope and survival (and may, in some cases, offer to provide a stapled buy-side policy covering those more fulsome representations and warranties, in an effort to focus negotiations on issues of price or deal certainty rather than indemnification coverage).

This is in part due to the fact that in some respects, RWI generally provides coverage beyond what deal makers generally consider "market" terms as between buyers and sellers, as further discussed below.

Typically excluded from RWI coverage is the insured's actual (and in some cases, constructive) knowledge of a breach of a representation or warranty. Because sellers are generally presumed to have greater knowledge than buyers with regard to breaches, buy-side policies are thought to provide broader coverage and therefore tend to be more expensive than sell-side policies.

It is worth noting, however, that insurers of a sell-side policy may distinguish among sellers as it relates to knowledge (e.g., management's knowledge of a breach may not necessarily preclude recovery by an unaware institutional investor).

From a seller's perspective, a sell-side policy may be advantageous even where a buyer does not insist on or attribute much value to RWI coverage. Where exposure in respect of indemnification liability is beyond a seller's comfort level, whether as a result of negotiations with the buyer or the seller's perception of the creditworthiness of his co-indemnitors, RWI may reduce that exposure and reinstate the seller's comfort. Because any seller may recover under a sell-side policy for the full amount of the coverage, this may reduce a seller's dependence on contribution from jointly liable co-indemnitors.

Basic Economics

The premium for a RWI policy typically ranges from 1 percent to 6 percent for each dollar of coverage, based on an insurer's assessment of risk, the quality of the representations and warranties, the retention, the coverage limit and the policy period. For most deals, however, the premium is between 2 percent and 3 percent and as discussed above, slightly higher for buy-side policies than sell-side policies. Other up-front costs may include underwriting or diligence fees and other governmental taxes and fees (e.g., state surplus line taxes).

The principal terms of a RWI policy are similar to familiar indemnification terms in an acquisition or merger agreement. Deductibles, caps and survival periods in acquisition or merger agreements are analogous to retentions, limits and policy periods, respectively.

The retention is the insured's aggregate deductible under the policy. It generally ranges from 1 percent to 3 percent of enterprise value, although it is not uncommon for an insured to negotiate one or more step-downs in the retention so that the retention decreases over time if it is unused.

Although lower retentions may be available in certain cases and at higher premiums, insurers may require that the retention be exclusive of any indemnification deductible or threshold in the acquisition or merger agreement so that the insured has actual dollars at risk before it can recover on a claim against the RWI policy.

The coverage limit under a policy is the insurer's liability cap. Parties may set the coverage limit relative to the escrow or indemnification cap in order to backstop, replace or extend an indemnification package, depending on the parties' objectives. Many insurers will insure up to approximately $50 million individually, but parties looking for additional coverage can stack policies from multiple providers into an insurance tower with coverage upwards of $300 million.

Like coverage limits, parties may set the RWI policy periods relative to the indemnification survival periods in the acquisition or merger agreement so that the duration of the RWI coverage covers or extends the indemnification package or provides one where one would not otherwise be available (e.g., in the context of a public company acquisition).

RWI policy periods generally exceed indemnity survival periods for general representations and warranties and applicable statute of limitation periods for fundamental representations and warranties. For example, RWI policy periods may extend for two to five years for general representations and warranties (although extended periods may be available) and five to seven years for fundamental representations and warranties (including tax representations and warranties).

Conclusion

RWI may allow parties to efficiently allocate risk and increase deal value. It may also be implemented to strategically change the dynamics in a competitive process and, when considered early in a deal, may be determinative in whether a deal gets done.

Parties should consider and evaluate its use in light of the facts and circumstances of the proposed transaction to determine whether RWI is appropriate in their particular circumstances and, if so, how it should be structured. Even when parties opt against RWI at the outset of a deal, that calculus may change as the transaction evolves, and deal makers should be conscientious about whether and when to re-evaluate RWI throughout the course of negotiations.

An understanding of the interests of the parties involved, and the various mechanisms available to address those interests, is critical to negotiating a RWI deal between a buyer and a seller, as well as between the deal parties and the insurer.

REPRINTED WITH PERMISSION FROM THE JULY 31, 2013 EDITION OF *LAW360* © 2013 PORTFOLIO MEDIA INC. ALL RIGHTS RESERVED. FURTHER DUPLICATION WITHOUT PERMISSION IS PROHIBITED