Client Alert

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Representations and Warranties Insurance - What Parties to Acquisition Financings Need to Know

I: Introduction

Representations and warranties ("reps and warranties") insurance has become increasingly prevalent in recent years. Although reps and warranties insurance has been widely used in Europe and Asia for several decades, use of this insurance has become widespread in the United States only in the last six or seven years. It is estimated that approximately 30 percent of all North American M&A transactions in 2018 involved reps and warranties insurance.[1] For M&A transactions involving a private equity buyer—which transactions are more likely to involve material debt financing—the number rises to over 60 percent. Between market volatility, increasing pressure to close deals quickly and a drop in policy costs, this insurance has become an important part of M&A deals and related financing transactions.[2] Borrowers undertaking acquisitions and lenders seeking to finance acquisitions should understand reps and warranties insurance policy procedures and considerations, scope of coverage and how lenders can leverage such policies to protect their interests.

II: What is Reps and Warranties Insurance and Why is it Relevant in Financing Acquisitions?

Reps and warranties insurance is used in M&A transactions to protect against losses resulting from a seller's breach of the reps and warranties in the purchase agreement. Insured parties can protect themselves from post-closing losses based on unanticipated and unknown breaches. Although policies can be purchased by the buyer or the seller, it is more common for the buyer to be the insured party.

When the buyer is the insured, reps and warranties insurance is also frequently used to modify the traditional deal structure. A buyer-side policy allows the buyer to substitute, in whole or in part, insurance for the seller's indemnification obligation. Rather than setting aside a large escrow or having the seller responsible for a significant damages cap, the parties can agree to a smaller escrow, or no indemnity at all, with the insurance policy serving as the main source of recovery. Accordingly, the advent of reps and warranties insurance has resulted in significant limitations on a seller's indemnification obligations or, in many cases, elimination of those obligations altogether. As lenders have traditionally obtained comfort against post-closing losses through collateral assignment of the buyer's right to indemnification from the seller, lenders must now ensure that this loss of protection is replaced, in whole or in part, by the right to proceeds from claims paid by the rep and warranty insurer.

Lenders desire a stake in the reps and warranties policy because it can be a valuable part of their collateral package, not unlike a borrower's (or target's) casualty and general liability insurance. Paying attention to

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[1] Reliable industry data is not publicly available. Brokers and some insurers publish limited data from which broader industry statistics can be extrapolated. *See,* e.g., Aon, North America M&A and Transaction Solutions – Risk in Review 2019 (2019), https://www.mergermarket.com/info/info/risk-review-2019-north-america.

[2] *Id*.

the terms of the reps and warranties insurance can be critical to lenders, especially considering that the insurance may be the loan parties' primary means of recourse against a seller's breach.

III: Policy Considerations for Borrowers and Lenders

There are some basic considerations for borrowers (the buyer in the underlying acquisition) and lenders as they begin thinking about reps and warranties policies:

1. **Duration of Policy.** Reps and warranties insurance will provide three years of coverage for breaches of standard reps and warranties and six years of coverage for breaches of fundamental reps and warranties as well as post-closing tax losses. This coverage is significantly better than the average period during which a seller would traditionally be required to indemnify a borrower, although many traditional indemnities would allow the borrower to seek indemnification for certain losses (e.g., breaches of fundamental reps and warranties and reps and warranties related to environmental matters, employee benefits and tax matters) for an extended or indefinite period.

2. **Cost and Coverage Limits.** The insurer will typically charge a premium of 2-3 percent of the policy limit. Together with related fees and taxes, the overall cost of the policy can range between 3-5 percent of the policy limit. A coverage limit of 10 percent of the purchase price is common. Insurers have minimum premiums, making smaller transactions (less than $50 million) difficult to insure.

3. **Retention/Deductible.** Retentions are typically between 0.75 percent and 1.25 percent of the target's enterprise value. The retention amount will usually reduce after the one-year anniversary of closing, often to as little as 0.50 percent of purchase price. Parties often structure transactions so that the seller provides an escrow or indemnification coverage up to the amount of the retention such that the borrower should not be liable for any losses up to the limit of the policy.

4. **Definition of Loss.** Carriers are typically willing to be silent with respect to consequential damages and damages based on a multiple and allow for a fact finder to determine the amount of damages (as opposed to having blanket exclusions for those types of damages).

5. **Materiality Scrape.** Carriers are typically willing to recognize a "materiality scrape"—the exclusion of any materiality qualifier from a seller's reps and warranties—for purposes of determining the existence of a breach of a rep and warranty or, if the purchase agreement does not contain a materiality scrape, policies will sometimes include a provision "reading out" materiality qualifications in the reps and warranties, making the coverage for breaches significantly more valuable to the borrower.

6. **Exclusions.** Lenders should pay attention to exclusions from coverage in order to ensure the policy provides adequate protection. Rep and warranty insurance coverage will always exclude losses arising from facts and circumstances known to the insured. This will include items disclosed in the disclosure schedules to the purchase agreement as well as anything that arises in the course of the borrower's due diligence investigation. Such exclusions are limited to "Actual Knowledge," defined favorably for the borrower. Other common exclusions include forward-looking statements, transfer pricing, working capital adjustments, asbestos and PCBs, and pension underfunding. Additional exclusions are often included based on the results of the insurer's underwriting exercise. Lack of adequate due diligence by the borrower, an unfavorable history of claims or inadequate policies and procedures can all result in exclusions, some of which may be material to the borrower and the lender.

7. **Subrogation.** Typically, in buyer-side reps and warranties policies the insurer will be able to step into the shoes of the insured and recover against the seller only in limited instances, such as in cases of fraud.

IV: Capturing the Benefits of Reps and Warranties Insurance as Collateral

Initial Steps and Due Diligence Phase

At the outset, lenders should inquire whether a buyer-side reps and warranties insurance policy will be purchased and if not, consider whether it is appropriate to require a policy be in place. Lenders might consider this requirement if the seller's indemnification obligation is limited or adequate post-closing recourse against the seller is uncertain. In some instances the buyer and seller may have agreed that post-closing indemnification will be limited to an amount set aside in escrow. If so, lenders should be comfortable that such amount will be sufficient to cover anticipated losses.

If a reps and warranties policy will be put in place, lenders should request that they and lenders' counsel be included in distributions of the documents and be kept informed about decisions regarding the policy, including aspects of the underwriting process.

As documents become available, lenders should review the insurance documentation, keeping the policy considerations above in mind and ensuring that the perfection steps below are taken. In particular, lenders should comment on the coverage limits, exclusions, deductibles/retentions, assignability of the policy and the subrogation rights of the lenders. The lenders should also ensure that the named beneficiary is a loan party, as this will ensure the lenders can take a collateral assignment of the policy.

Commitment Letter and Documentation Phase

The Loan Syndications and Trading Association (the "LSTA") hosted a webcast in the spring highlighting how representations and warranties insurance affects lenders.[3] In the commitment letter and documentation phase, the LSTA recommends lenders take the following steps:

1. Consider asking for the administrative agent to be an additional insured or loss payee of each reps and warranties policy in the description of the collateral. However, most insurers will not permit this and it may not be necessary if the lender can obtain a collateral assignment of the policy.

2. Make provisions of the policy applicable to each future permitted acquisition for which there is a reps and warranties policy. If the borrower undertakes any later permitted acquisitions, the lender will want to ensure the initial documents require the same lender protection provisions apply to these subsequent acquisitions.

3. In the reporting covenants in the loan agreement, consider requiring notice of claims and delivery of material correspondence under each reps and warranties policy.

4. Ensure affirmative covenants in the loan agreement require diligent pursuit of any claims under each reps and warranties policy.

5. Consider whether proceeds from policy claims should be subject to any mandatory prepayment requirements in the loan agreement.

6. Obtain a collateral assignment of each policy and record the collateral assignment with the insurer. The UCC excludes insurance from its scope, so a general security agreement and UCC financing statement is not sufficient.

[3] Loan Syndications and Trading Association, *Capturing the Benefits of Representations and Warranties Insurance in Acquisition Financings – What Lenders Need to Know (and Do)* (April 17, 2019), https://www.lsta.org/events/capturing-the-benefits-of-representations-and-warranties-insurance-in-acquisition-financings-what-lenders-need-to-know-and-do/#presentations.

7. If appropriate, consider making the effectiveness of the policy and receipt of the collateral assignment a condition subsequent to closing. Lenders should keep in mind that final policies are often not delivered at closing and may be subject to the satisfaction of conditions subsequent, such as payment of the premium and delivery of a final copy of the transaction data site.

Reps and warranties insurance policies are usually committed immediately following or in conjunction with the execution of the purchase agreement. Insureds will pay a nonrefundable deposit and agree on the form of policy with the insurer. Coverage is bound and the policy becomes effective at the closing of the transaction. Lenders should be sure to receive copies of any binder agreement and the final policy documentation when it is available (typically at closing or within 30 days of closing). Lenders should also take steps to ensure that the insured satisfies all conditions subsequent to the binding of the policy including payment of the balance of the premium.

V: When is Reps and Warranties Insurance not an Appropriate Solution?

Loan parties should be aware that the use of reps and warranties insurance is not suitable in all transactions. In addition to the added costs, there are several factors that might force parties to rely solely on more traditional indemnification structures.

1. **Material Known Liabilities.** Sellers will indemnify borrowers for losses resulting from known liabilities. Coverage for such liabilities is not available under a reps and warranties policy. Such contingent liabilities might include ongoing litigation, environmental problems or identified violations of law.

2. **Identified Risks.** If the underwriting process reveals risks that result in significant or numerous exclusions, obtaining coverage may not make sense. Such risks might include past litigation, past audits, aggressive tax planning, products liability issues, and missing or inadequate due diligence.

3. **Small Deals.** Reps and warranties insurance can be cost-prohibitive for transactions valued less than $50 million due to minimum premium requirements.

4. **Certain Industries/Risks.** Some insurers will not insure certain industries or certain risks. If the target operates in such an industry or is subject to a specific type of risk, coverage may not be available or only a small number of carriers may be willing to write the coverage and costs may be higher.

It is worth noting that other transactional insurance products are available to address some risks that cannot be covered under a reps and warranties policy. Lenders should be aware of such products and suggest them to borrowers as an alternate means of obtaining adequate post-closing comfort for breaches of reps and warranties by a seller or for existing contingent liabilities. For example, insurers will cover certain tax positions taken by the seller or by the parties as part of the consummation of the transaction. Insurance is also available for ongoing litigation.

VI: Claims

The data surrounding claims is very limited and it is important to remember that any data available provides only a limited snapshot. However, with this in mind, AIG (one of the largest providers of reps and warranties insurance) reports that the overall frequency of claims across all deals on a global basis has stayed steady over the past few years at 20 percent, although in 2018, there was an increase in claims notifications for M&A deals between $500 million and $1 billion from 21 percent to 26 percent.[4] The frequency of claims size varies by deal size—41 percent of claims were for less than $1 million, 44 percent

[4] AIG, Taxing Times for M&A Insurance (2019), https://www.aig.com/m-and-a-claims.

of claims were for between $1 million and $10 million and only 15 percent of claims exceeded $10 million.[5] The most frequent bases for claims were for breaches of reps and warranties related to financial statements (19 percent), tax (18 percent) and compliance with laws (15 percent).[6]

VII: Reps and Warranties Insurance in Asset Transactions and "Going Private" Transactions

In asset sales, reps and warranties insurance coverage can be leveraged in a slightly different manner. In addition to coverage for breaches of reps and warranties, buyers can obtain coverage for defense costs if the buyer is drawn into claims related to liabilities not assumed in the asset purchase agreement. As the ability to exclude liabilities in asset purchase transactions provides significant potential advantages to buyers, coverage for claims related to such liabilities further narrows a buyer's exposure for such liabilities.

Reps and warranties insurance can also be used in "going private" transactions to provide buyers with some protection where traditionally no seller indemnification would be available. In going private transactions, the numerous and unrelated public shareholder sellers are not able to provide indemnification to the buyer and, as a result, the public company usually makes very limited reps and warranties. This results in limited post-closing recourse for the buyer, who simply has to accept the risk of a breach. However, by using reps and warranties insurance, a buyer can now obtain some post-closing protection and limit the risks associated with acquiring a public company.

VIII: Conclusion

Reps and warranties insurance has become an important part of M&A transactions. As reps and warranties insurance has become increasingly prevalent and as it is used to alter traditional deal structures, it has also become an important part of the acquisition financing by providing lenders with a means of protecting their interests in the collateral and in the overall success of the business being financed. Although reps and warranties insurance is still relatively new in the United States, its use is likely to continue and possibly even expand, particularly as the M&A market becomes more informed. Borrowers and lenders alike can use this insurance to protect themselves in M&A deals and the related financing transactions. As reps and warranties insurance may be the primary means of recourse against a seller's breach, borrowers and lenders should pay close attention throughout the process, keeping in mind the policy considerations and guidance noted above.

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[5] *Id*.

[6] *Id*.