WOODRUFF SAWYER

Guide to Representations & Warranties Insurance

2024 Edition

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The use of representations and warranties insurance (RWI or R&W) has become increasingly mainstream. An estimated 75% of private equity transactions and 64% of larger strategic acquirers use it. Woodruff Sawyer's R&W team presents this comprehensive look at this facet of coverage.

9 Reasons to Use Representations & Warranties Insurance

RWI is a well-established tool in the merger and acquisition (M&A) toolbox for both private equity and strategic buyers. Broad coverage and competitive pricing have been the theme for 2024. RWI has been widely adopted because it can be used to:

1. **Use Profit from a Sale More Quickly:** R&W insurance can reduce or remove escrow for an M&A transaction, which allows the seller to either reinvest, realize, or more quickly distribute the proceeds they receive. It also allows the buyer to offer a quicker, cleaner process, which matters a great deal in a seller's market. Now that it is more established, R&W insurance has become a requirement for many sellers who are backed by private equity or venture capital.
2. **Avoid Post-Close Conflict:** Having spent a vast amount of time and money acquiring a management team as part of the M&A process, no buyer wants to fight an escrow battle or file suit against the seller. A buy-side policy can make the buyer whole without any attacks on their new people.
3. **Mitigate Concern Surrounding Seller Solvency:** If the seller is a smaller business that will cease to exist after the deal is done, there may not be an accountable party to pursue if/when a claim arises. A seller who backs up their promises with an A+ rated policy removes that concern. With the current volatile economy, we expect this reason to become more pressing.
4. **Streamline Negotiation:** As any seasoned practitioner of M&A will tell you, negotiating indemnification is often the most challenging and time-consuming aspect of a transaction. Using insurance as a security backstop against any breaches or unforeseen costs often makes for a quick and easy negotiation process.

5. **Have an Extra Pair of Eyes:** While bringing a third party into a transaction may concern you, R&W underwriters genuinely have your best interests at heart. Neither party wants a problem post-close. A team that provides an impartial review of previous due diligence is a valuable contributor to the process. This step can also potentially serve as a defense when other shareholders accuse a buyer of not doing adequate diligence.
6. **Choose Your Protection:** A buy-side policy allows the buyer to purchase a limit of their choosing without needing the seller to agree to the same amount of liability.
7. **Gain Peace of Mind:** Many strategic buyers are buying assets with the intention of expanding their reach or offering. This strategy can mean entering territory where they have less experience. An R&W policy helps protect the buyer from what they don't know.
8. **Present Competitively in an Auction:** Several years ago, private equity firms started buying R&W coverage because it helped them win bids. Increasingly, an offer to buy R&W is becoming table stakes in a transaction. A lack of understanding of the product could be costly for bidders.
9. **Follow the Best Practice in Corporate Governance:** Litigation around M&A transactions is practically continuous. Having a strong RWI policy with robust limits can be a bulwark against claims of inadequate diligence and gives the buyer a chance to be made whole in the event of a problem arising post-close.

What Is Representations & Warranties Insurance?

Read our blog:
Reps & Warranties Insurance Basics →

R&W insurance is essentially a breach-of-contract coverage designed to enhance or replace the indemnification given by the seller to the buyer. In short, once the ink has dried on the merger or acquisition deal, R&W covers loss caused by any breaches of the seller's representations, whether it involves issues with their customer contracts, employment agreements, or the super-secret recipe of their product (i.e., intellectual property or "IP").

The indemnity package is usually the most contentious part of any merger or acquisition negotiation. R&W steps in to eliminate contention and provide everyone with a cleaner, faster, and safer deal.

Jump to: Expert insights into the current RWI underwriting market.

Who Uses Insurance in an M&A Transaction?

- Corporate buyers who want the ease RWI brings to the transaction and are seeking to maximize their attractiveness to potential sellers
- Private equity firms looking to maintain strong relationships with management post-close
- Private equity firms that want to close a fund and/or mitigate claw-back risk
- Public companies looking to protect the balance sheet after they divest a subsidiary
- Private sellers seeking safeguards in a sale

What Problems Can RWI Address and How?

- Overcome obstacles in the negotiation of the transaction
- Extend the life of the warranty or the dollar amount of protection
- Bridge the gap between the desires of the seller and the buyer
- Partially fund shortfalls in the escrow
- Achieve better investment returns and hasten access to funds
- Improve the financial standing of reps given by a distressed company

Jump to: Up-to-date expertise on secondaries insurance.

Key Elements of an R&W Policy

Let's walk through how R&W insurance works, how it's placed, and what it costs. We will also look at likely developments in the coming year.

Here are five buy-side details that provide more explanation:

1. Buy-side policies have additional fraud coverage that sell-side policies can't provide.
2. The insured buyer can pick a coverage limit and survival period (i.e., the period for which the policy is in place) beyond what the seller is willing to give.

Read our blogs:
Buy-Side vs. Sell-Side Policies- Which is Best for You? Part 1 ⟶

Part 2 ⟶

3. With this coverage, the buyer can avoid suing their newly acquired management team. Should any breaches or misrepresentations come up, they can go directly to the carrier.
4. Buy-side policies allow the buyer to offer lower escrows or more competitive terms in an auction.
5. This insurance can replace distressed company indemnification with A+ rated indemnification.

Jump to: Tax liability insurance and what it can do for you.

How Underwriters Assess M&A Risk

When drawing up the R&W policy, underwriters evaluate:

1. The nature of the sale purchase agreement (SPA) terms and conditions. Examples include the definition of loss with regard to multiples and consequential damage language, single or full materiality scrapes, and sandbagging language. Underwriters prefer language that is not strongly in favor of neither buyer nor seller.
2. The nature of the specific warranties being given in the context of the transaction. For instance, IP warranties will be scrutinized more specifically in a tech deal than a manufacturing one. Buy-side policies allow the buyer to offer lower escrows or more competitive terms in an auction.
3. The quality of the due diligence. Underwriters wish to provide coverage for the unknown, so they are looking to “diligence the diligence.” With strategics increasingly using this factor, underwriters also want to ensure the policy will be in a clear format, whether the diligence is done in-house or by external advisors.

Placement Process and Timing for Coverage

Placing R&W coverage is a two-part process:

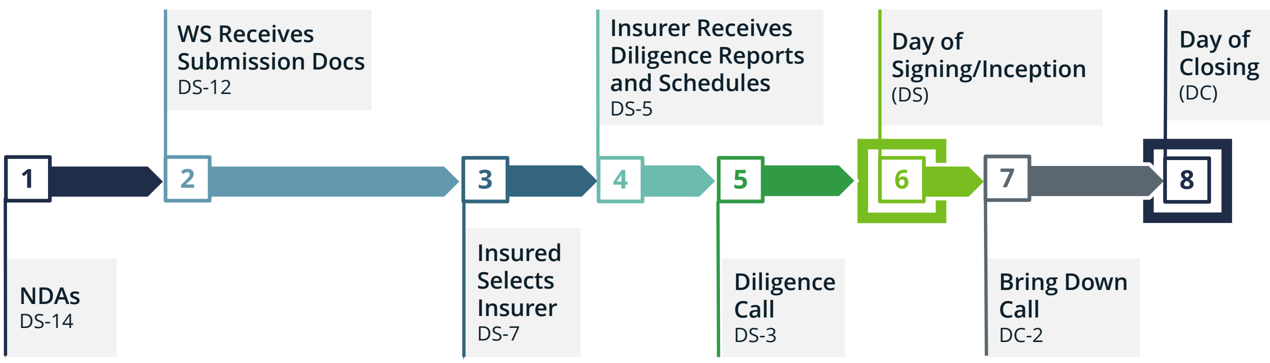
1. Initial non-binding indication occurs one week after receiving the target financials, draft sale and purchase agreement, and any information memorandum that has been prepared by the seller. Underwriters provide initial indications on premium, retention, areas of concern, or heightened risk. This step costs nothing.

2. Underwriting requires a $30,000–$45,000 up-front "diligence fee." Underwriters and their counsel are granted access to the data room and begin reviewing the diligence reports and the disclosure schedules. This step involves a two- to three-hour diligence call with underwriters, deal team members, and third-party diligence providers. Twenty-four hours after the call, underwriters will provide a draft policy and any follow-up questions. It doesn't make sense to start underwriting before the diligence is almost complete and a draft disclosure letter has been produced.

Securing R&W Insurance within the Deal Flow Timeline

Let's break down the insurance process a little more and see how it fits into the deal flow.

Step-by-Step Woodruff Sawyer Process



Note: "DS" is day of signing and "DC" is day of closing, and the numbers after them refer to how many days before those events take place. For example, "DS-12" means that 12 days before signing is when something needs to happen.

1. Woodruff Sawyer sends a non-disclosure agreement (NDA) to the market for execution, and it is sent back with any redlines.
2. Insured sends Woodruff Sawyer the following: (i) draft agreement; (ii) target financials; and (iii) confidential information memorandum (CIM)/investor presentation. Woodruff Sawyer prepares the submission and sends it to the market.
3. Woodruff Sawyer sends a proposal to the insured. The proposal includes all markets approached, all prices quoted, and a line-by-line breakdown of comparison between the three most competitive offers. Insured selects insurer with which to proceed.
4. Once non-reliance letters (NRLs) are executed, the insured sends Woodruff Sawyer all diligence reports, the most up-to-date sale purchase agreement (SPA), and a draft of the disclosure schedules. Woodruff Sawyer schedules the diligence call.

5. Diligence call with insured, insurer, and advisors. The insurer sends follow-up questions and an initial draft of the policy after the call.
6. The insured sends Woodruff Sawyer: (i) signed/dated inception no claim declaration (NCD); (ii) execution copy of the agreement; (iii) execution copy of the schedules; and (iv) bind order. Coverage is bound.
7. Woodruff Sawyer schedules a bring down call with the insured and insurer.
8. The insured sends Woodruff Sawyer signed/dated closing NCD. Post-close, the insurer issues the final policy after it receives (i) data room; (ii) closing volume; and (iii) premium.

5 Main R&W Exclusions

R&W insurance is continually evolving. There are four buckets of exclusions you generally find in a policy, as well as one common practice that functions similarly to an exclusion.

1. Conduct/Behavior Exclusions

The buyer is required to sign a “no claims” declaration at the start of a policy. If they make a false statement about what they know, that could potentially nullify any claim related to that fraudulent statement, if not the entire policy. Crooks beware, though: if the insured is the buyer, they are protected against any fraud by the seller but not against their own fraud.

A standard exclusion on a policy would be “any issue known prior to signing/closing,” or a similar version of that. Defining and interpreting this exclusion is a vital issue, and its breadth is highly dependent on the specifics of the language.

For instance, let’s say there is a piece of litigation related to licensing, and further diligence proves this to be an isolated incident. It would be reasonable to exclude that piece of litigation specifically but not licensing as a whole.

On the other hand, if diligence uncovered that this one piece of litigation was the tip of the iceberg, and the target company had a history of failing to apply for proper licenses, then the whole subject of licensing might be excluded.

2. Standard Exclusions

Net Operating Losses and Tax Credits

Net operating losses and tax credits have been an exclusion for a long time, although we have recently seen some shift in its application. This exclusion can now be dependent on the nature of the target and the amount of diligence around the area. Tax indemnity policies are also available to cover this more specifically if a favorable opinion has been written.

Read our blog:

M&A Litigation and the "Bump Up" Exclusion →

Wage and Hour

Long a standard exclusion, we're also seeing movement toward a more "case-by-case" attitude among underwriters. For example, we are more likely to see this exclusion applied to a deal in the retail space than in the software space.

Forward-looking Warranties

While this element remains in full force as an exclusion, we have seen a shift of onus. We now expect underwriters to draw attention ahead of time to those warranties which they believe have a forward-looking element, rather than having this be a potential guessing game.

Underfunding of Pensions

This exclusion continues to be a standard one.

3. Deal-Specific Exclusions

Deal-specific exclusions refer to specific known issues or problems inherent in the industry for which underwriters will not accept liability, such as Medicare/Medicaid in healthcare (although it is increasingly possible to get coverage in this area) or FCPA in construction.

As with all exclusions, the tightness of the language is key and, as discussed above, getting granular on known issues is vitally important.

Try to identify the kind of breaches you are most likely to have—whether it's intellectual property (IP), cyber concerns, or environmental—to make sure your organization focuses their diligence to aid in removing those exclusions from the policy.

4. World Event Exclusions

In early March 2020, exclusions related to COVID-19 (including any resulting COVID-19 sickness, SARS-CoV-2, or any mutation or variation thereof) started showing up in R&W policies.

Since then, we have also seen the addition of exclusions relating to Russia's invasion of Ukraine and the collapse of Silicon Valley Bank.

Read our blogs:

COVID-19 Exclusions Continue to Play a Major Role in RWI ⟶

The Impact of the Russian Invasion of Ukraine on the RWI Market ⟶

5. Deemed Deleted/Altered Language

Although not strictly speaking an exclusion, deemed deleted/altered language functions in much the same way, and we are seeing an increase in its use. In this way, the underwriter can take a scalpel to a particular representation or warranty rather than excluding the whole thing. A good example is the addition of a knowledge qualifier so that a representation reads "to the knowledge of the seller" rather than as a flat representation. Obviously, this would only be for the purposes of the policy and wouldn't impact on the agreement at all.

Market Insights

The Current RWI Underwriting Market

Tyson Freeburg
Team Lead,
Transactional Insurance Group

While deal flow has increased in 2024, it is not extremely high. RWI underwriters are getting creative in how they remain competitive in a saturated market without simply dropping premium rates in a race to the bottom.

While premium rates do remain at an all-time low, the market seems to have found a floor at around 2%–2.5% (down from 3.5%–4% in 2022). However, we are still seeing new underwriters enter the market, so competition remains high.

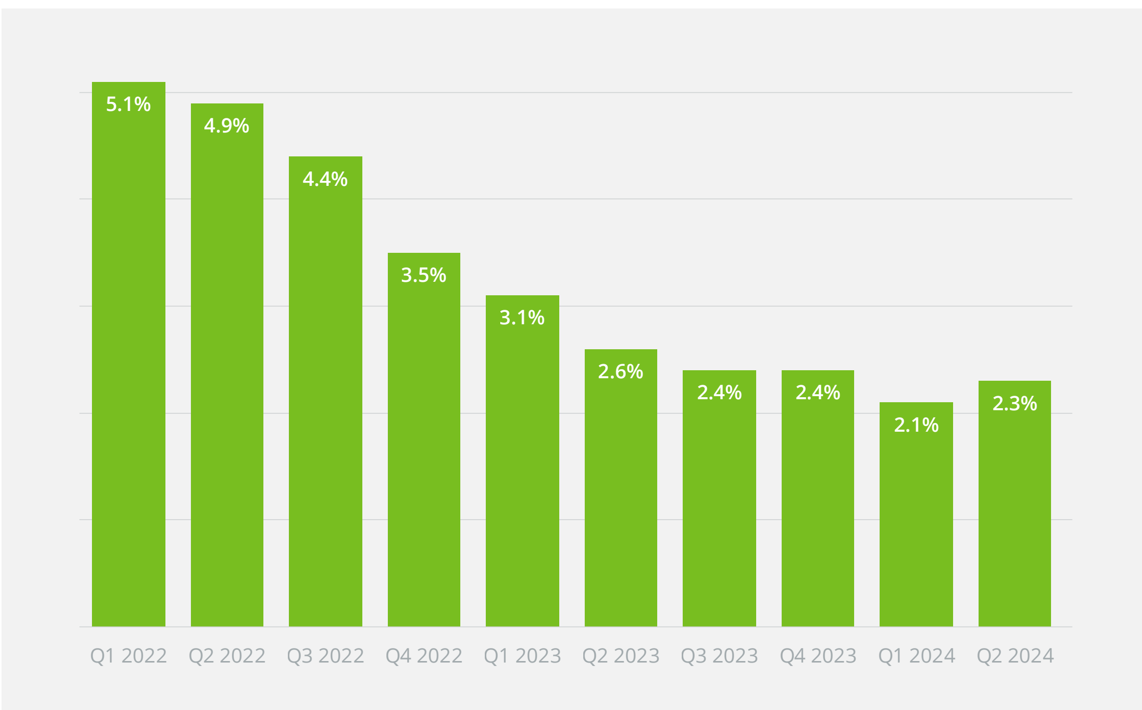
Retention

As recently as early 2023, the market-standard retention for RWI policies was 1% of a deal's enterprise value (EV). In mid-2024, the average retention rate typically falls in the range of 0.5%–0.7% of the EV. The difference between an initial retention of 0.5% versus an initial retention of 0.7% can be a big number—potentially hundreds of thousands of dollars, depending on the size of the deal.

Another area related to the retention we've seen underwriters incorporate into their quotes is a separate retention for fundamental reps, often set to 0%. When we see this mechanism built into the non-binding indication letter (NBIL), the range for the fundamental retention is typically 0%–0.25% of the EV. Statistically, there is a much higher likelihood of a breach from one of the general reps, so we tend to advise clients to focus more on the initial retention.

There are currently 28 underwriters vying for your affection in the US market. On any given deal, we will receive, at a minimum, roughly 10 NBILs. Often, the decision comes down to certain intangibles like previous experiences and longevity in the market.

Average Rate as a % of Limit by Inception Quarter for Bound Policies



Source: Woodruff Sawyer

What's New in RWI: Secondaries Transactions

Yelena Dunaevsky
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The use of a derivation of the traditional RWI product is growing in popularity for secondary transactions. These deals have proven useful to both limited partners (LPs) and general partners (GPs) who are looking to manage their portfolios during a stale or sluggish economic market. GPs use secondaries to offer liquidity to their legacy fund investors while holding on to promising portfolio companies that need more time to mature. According to a recent report by Lazard, the estimated aggregate secondary deal volume in 2023 reached almost $110 billion, with GP-led deals taking almost 45% of the market share.

There are a few motivating factors for parties to obtain RWI for these transactions. For the GP, the main motivator is a clean exit. For a lead investor in a fund from which the asset being transferred is the last asset in the fund, the motivator is the safety net obtained through RWI coverage where not much collateral is left in the fund.

The process of obtaining RWI coverage is almost always through a "seller flip." The GP will solicit quotes for RWI through an RWI broker and will post them in the electronic data room. Once the lead investor is identified, the insurance broker will be introduced to them and help to complete the process. The letter of intent (LOI) for this kind of transaction tends to be more negotiated than for a traditional M&A deal, yielding multiple updates and changes to the NBIL (also known as a quote).

The insurance underwriters typically take one of two approaches when underwriting these deals. In the first and predominant approach, there is almost no due diligence. The reps are all knowledge qualified, and the underwriting call is often no longer than 30 minutes. The second approach is more of a hybrid where the sponsor commissions full scope due diligence, the representations are similar to those in a traditional RWI deal, and the underwriting call is lengthier and more involved, similar to the traditional RWI underwriting call.

What Affects Pricing for Secondaries?

1

How many and which reps are knowledge qualified

2

The level at which reps are knowledge qualified

3

The nature of coverage

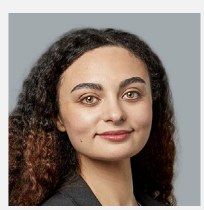
When underwriting this kind of coverage, the underwriters dig into the financials and tax positions of the fund. They like to see a fairness opinion because conflicts of interest is a pressure point, and valuation is also a big question.

The number of carriers who are quoting these deals has increased over the last two years, with 10 to 15 quotes coming in for each transaction. There are fewer carriers with lengthy experience in this space, and some are only quoting excess coverage. However, many are getting more exposure to these kinds of deals, so we expect more carriers to become more knowledgeable in this kind of coverage.

Read our blog:
Insurance Coverage for Secondaries →

Tax Liability Insurance: Coverage for Known Tax Exposures

RWI will cover breaches of tax covenants that were unknown and occurred prior to the acquisition. However, it does not offer a solution for known tax exposures. In this instance, a tax liability policy is invaluable. Tax liability insurance protects a taxpayer if a taxing authority challenges the insured's tax position.



Lauren Trapp
Account Manager, Transactional Insurance Group

A few examples of insured risks include:

- Tax-free re-orgs
- REIT status
- S-corporations
- Renewable energy (Investment and Production Tax Credits)

Subject to certain terms and conditions, tax liability policies provide coverage for taxes owed, as well as associated interest, fines, penalties, and defense costs. In addition, coverage may include a "gross-up" to reimburse the buyer for any income taxes assessed after a covered claim has been paid.

Standard exclusions include:

- Changes in law (e.g., treasury regulations & IRS code)
- Inconsistent tax filings (insured files a tax position that differs from the position covered under the policy)
- Material misrepresentations in the representation letter

In all events, tax liability insurance is an excellent way for buyers to protect their investment and alleviate the need to self-insure or negotiate an indemnity escrow. It provides both peace of mind and a smoother M&A process.

Claims Trends

Stacey Hammer
Account Executive, Transactional Insurance Group

From mid-2020 through mid-2022, we saw a large uptick in the number of policies and limits bound, and so it stands to reason that the number of R&W claims received by insurers has increased in the past year. Statistically, claims are most likely to arise within the first 12 to 18 months after a policy is bound since the first audit cycle of the target company's finances may bring to light certain breaches—leading to the current increase in claims.

The two largest categories in which claim payouts were made continue to be breaches of (1) financial reps, and (2) customers and contracts. Those two categories account for almost two-thirds of claim payments, with compliance of laws coming in at a distant third. Most claims tend to arise within the first 12 months of the policy period, and the earliest reported claims tend to result in severe losses since these material matters are often discovered shortly after the deal has closed.

Transactions involving targets with audited financials (versus unaudited financials) often result in greater losses and a higher likelihood of claims alleging financial rep breaches. Payments for financial statements claims involving targets with audited financials averaged 41.4% of the policy limit, whereas this figure is only 22.1% for payments involving companies with unaudited financials.

Significant claim activity is increasingly on the smaller end of the spectrum, with deals of less than $250 million enterprise value resulting in 60% of claim payouts. Smaller deals show a higher incidence of breaches related to compliance with laws reps and operations, whereas in larger transactions, breaches of intellectual property and tax reps are more common. There is still a high incidence of claims for breaches of financial reps among deals of all sizes.

Types of Breaches Reported in RWI Claims

Note: Respondents were allowed to select more than one answer.

Source: Lowenstein Sandler RWI Insurance Claims Report 2023

Read our blog:

Reps and Warranties Claims Trends: A 2023 Review ⟶

Choosing a Specialty Broker

R&W insurance has been around in various forms for several years, both in Europe and the US. However, in the last five years, we have seen a major shift in its use and format. It is essentially a new but no longer emerging product.

This status is true both in terms of the product itself and the markets that write it. Four years ago, six long-term, stable markets wrote R&W in the US. Today, there are 26, and each market is different.

What to Look For—and Watch Out For

When picking an underwriter, terms and conditions and pricing matter, but also look out for the makeup of the team. Do they have insurance professionals as well as those with M&A experience?

- Does the underwriter manage a general agency? How long has it been underwriting?
- How committed is the underwriter to this space?
- How does the agency or underwriter handle claims, and what experience does it have with claims to date?

It's important to remember that some of this guidance applies to brokers who will help you pick the most appropriate market for your risk. Many brokers are new to this product or only handle it occasionally and don't have tenured relationships with the underwriting markets or depth of experience with the product.

Beware the "boutique broker" who only focuses on reps and places no other lines of coverage. Because R&W interrelates with all the company's insurance lines, all those coverages need to be reviewed by experts. You may need to put other insurance in place, so it's important to have a broker who can handle all aspects of your situation.

Woodruff Sawyer believes that clients are best served by having a team dedicated to R&W day in and day out, with access to broader resources that can review all your organization's insurance needs and present a holistic solution.

R&W insurance is a complex and fast-growing marketplace. It requires a dedicated insurance broker who understands this type of coverage and is backed by the resources to handle all insurance lines and questions that come out of a transaction.

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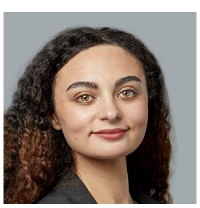

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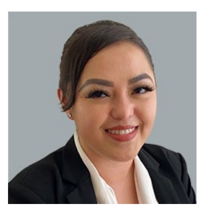

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Additional Resources

2024 M&A Looking Ahead Guide

Get analysis and predictions into the private equity and transactional markets.

Read our guide →

M&A Notebook

Gain insights on risk mitigation and due diligence for M&A deal activity.

Read our blog →

D&O Notebook

Get the insider's guide to critical information directors and officers need to know.

Read our blog →

2024 Board Education Resource Guide

Learn about board member educational and networking events, both in-person and online.

Read our guide →

Woodruff Sawyer Events

Join us at one of our events online or in a city near you.

Learn more →

About Woodruff Sawyer

As one of the largest independent insurance brokerage and consulting firms in the US, Woodruff Sawyer protects the people and assets of more than 4,000 companies. We provide expert counsel and fierce advocacy to protect clients against their most critical risks in property & casualty, management liability, cyber liability, employee benefits, and personal wealth management. An active partner of Assurex Global and International Benefits Network, we provide expertise and customized solutions to insure innovation where clients need it, with headquarters in San Francisco, offices throughout the US, and global reach on six continents.

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For more information

Call 844.972.6326, or visit **woodruffsawyer.com**