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Guide to Representations & Warranties Insurance



As Representations and Warranties (R&W) insurance becomes increasingly mainstream, Woodruff Sawyer's R&W team presents this comprehensive look at this facet of coverage—a growing concern in today's corporate climate.

8 Reasons to Use Reps & Warranties Insurance

While R&W has been around for some time, it has only gained popularity in the last few years. Today the process for obtaining coverage is more streamlined and you can achieve broader coverage at better pricing. While this has helped generate greater use of the insurance product, the following benefits demonstrate why R&W appeals more than ever to today's market. R&W insurance helps you:

- 1. Close the Transaction More Quickly:** R&W insurance can often be used to reduce or remove escrow for an M&A transaction. This allows the seller to either re-invest, realize, or more quickly distribute the proceeds they receive.
- 2. Achieve a Smooth Transition:** Having spent a huge amount of time and money acquiring a management team as part of the M&A process, no buyer wants to be in the position of having to fight an escrow battle or file suit against the seller. A buy-side policy can be written so the buyer can be made whole without having to attack their new people.
- 3. Negotiate Your Terms:** As any seasoned practitioner of M&A will tell you, negotiating the indemnification is often the hardest and most time-consuming aspect of a transaction. Using insurance as a security backstop against any breaches or unforeseen costs makes for a smoother and often shorter negotiation process.
- 4. Further Vet the Transaction:** While it may concern you to bring a third party into a transaction, R&W underwriters genuinely have your best interests at heart. Neither party wants a problem post-close. A team that doesn't do the diligence, but only reviews the diligence that has been done, can provide a valuable contribution.
- 5. Choose Your Protection:** A buy-side policy allows you to purchase a limit of your own choosing. You don't need the seller to agree to the liability and you can split up the protection however you want.
- 6. Gain Peace of Mind:** Many strategic buyers are buying assets with the goal of expanding their reach or offering. This can mean entering territory where they have less experience. An R&W policy helps protect the buyer from what they don't know.
- 7. Present Competitively in an Auction:** Several years ago, Private Equity firms started buying R&W coverage because it helped them to win bids. Increasingly, an offer to buy R&W is becoming table stakes in a transaction. Bidders can't afford not to have a good understanding of the product.
- 8. Mitigate Concern Surrounding Solvency of Seller:** 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.

What is Representations & Warranties Insurance?

R&W insurance is essentially 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 some of the unforeseen costs 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 (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 a cleaner, faster, and safer deal.

In a Merger & Acquisition (M&A) transaction, the Seller is usually required to indemnify the Buyer for breaches of the representations and warranties made in the Purchase & Sale Agreement. Representation & Warranties Insurance (R&W) can provide coverage to either the Buyer or Seller in an M&A transaction. The policy is triggered by a breach of warranties post-close and the loss is the diminution of value associated with that breach.

Key R&W Markets

AIG Ambridge Allied World ANV Arch
 Beazley Chubb CFC Underwriting
 Concord Specialty Dual Ergo Euclid
 Transactional Great American Hunter
 George Ironshore Liberty Markel
 Marketform Navigators QBE
 RiskPoint W.R. Berkley Tokio Marine
 – HCC Vale Insurance Partners
 XLCatlin Zurich

Pricing Parameters

- 2.5-4% of coverage limits required (e.g. \$10M at \$250K-\$400K)
- One-time payment for 6-year policy
- Pricing is dependent on the size of retention/escrow and other deal factors



R&W insurance is appealing to a broader market these days. In fact, the number of corporate buyers is almost at parity with the number of private equity buyers in the middle-market space.

Who Uses Insurance in an M&A Transaction?

- **Corporate Buyers:** With aggressive acquisition strategies
- **Private Equity Firms:** Looking to close a fund and/or mitigate clawback risk
- **Private Sellers:** Looking for safeguards in a sale

What Problems Can R&W Insurance Address?

- **Overcomes:** Obstacles in the negotiation of the transaction
- **Extends:** Life of warranty
- **Bridges:** The gap between the desires of the seller and the buyer
- **Partially Funds:** Shortfalls in the escrow, may be able to obtain better investment returns and/or hasten access to funds

What are Key R&W Insurance Issues?

- **Key Markets:** AIG, ACE, AWAC, Lloyd's (Ambridge), Beazley, Concord, Hiscox, QBE
- **Coverage:** Each contract is individually negotiated
- **Pricing Parameters:** Dependent on the size of retention/escrow and other deal factors; 2.5-4% of coverage limits required (e.g. \$10M at \$250K-\$400K)
- **Retention:** Customized to the deal
- **Underwriting Fee:** Typically \$15K-\$25K non-refundable fee due at the time of legal review

Key Elements of an R&W Policy

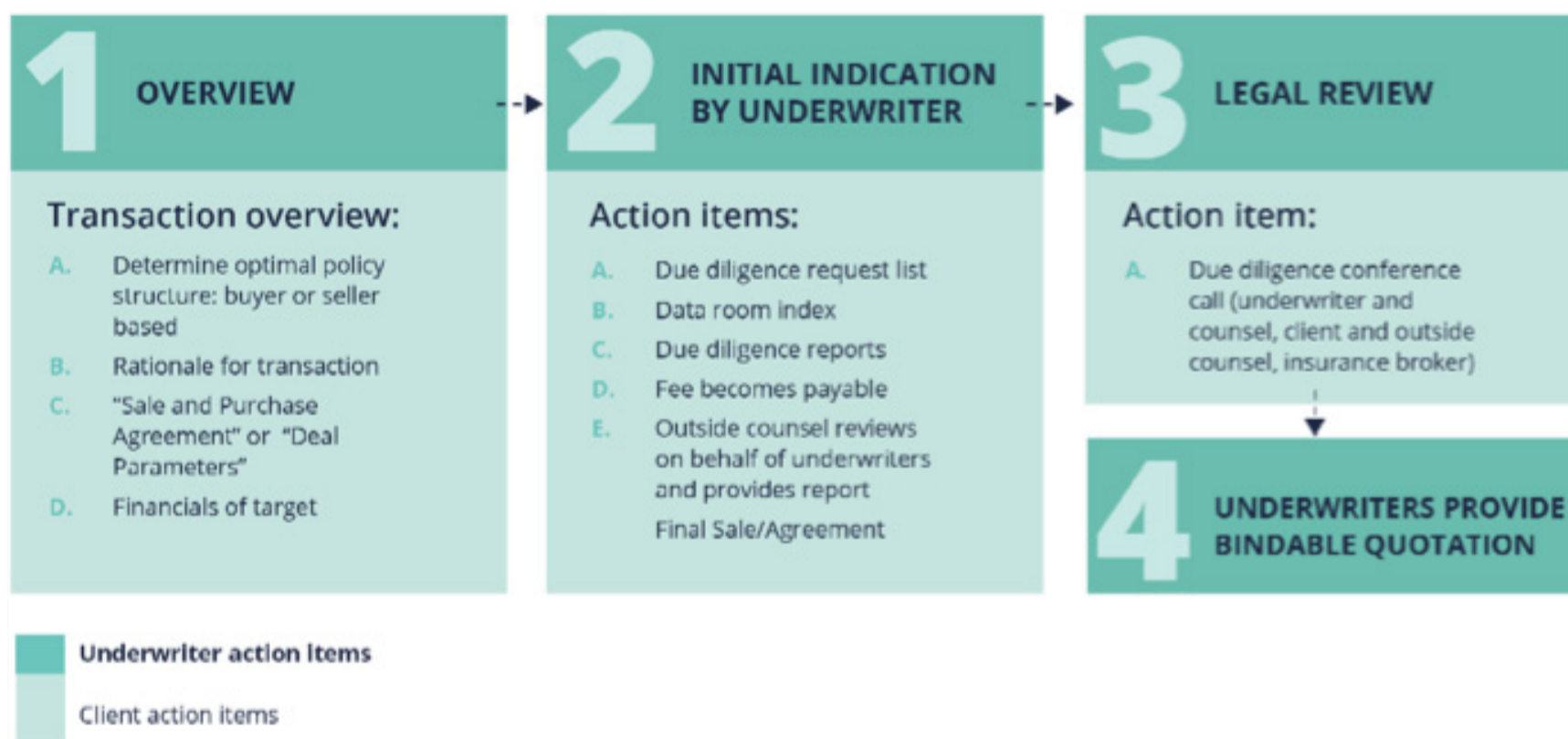
Now let's walk through how R&W insurance works, how it's placed, and what it costs. We will also look at likely developments in the coming year.

1. The Typical Policyholder

While either buyer or seller can be the insured, 90% of the policies placed are buy-side, protecting the buyer from any breaches of the seller's representations. Here are five buy-side details that provide more explanation:

- Buy-side policies have additional fraud coverage which sell-side policies can't provide.
- The insured buyer can pick a coverage limit and survival period (the time period for which the policy is in place) beyond what the seller is willing to give.
- 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.
- Premiums tend to be lower.
- Buy-side policies allow the buyer to offer lower escrows or more competitive terms in an auction.

For more information on buy-side vs sell-side, read our blog post, "Buy-Side vs. Sell-Side Policies—Which is Best for You? ["Part 1"](#) and the accompanying ["Part 2"](#) post.



2. How Underwriters Assess the M&A Risk

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

- The nature of the Sale Purchase Agreement (SPA) terms and conditions. Examples of this include multiples and consequential damage language, single or full materiality scrapes, and sandbagging language. Underwriters prefer language that is not strongly in favor of either buyer or seller.
- The quality of the due diligence. Underwriters wish to provide coverage for the truly unknown, so they are looking to "diligence the diligence."

3. The Exclusions

While the insurance is designed to cover all warranties, certain exclusions are standard:

- Forward-looking warranties (for example, sales projections, etc.)
- Purchase price adjustments
- The availability or usability of Net Operating Losses or R&D tax credits
- Areas of coverage that are difficult to get, such as FCPA violations, union activity, underfunding of pensions, wage and hour violations, etc.

4. Process and Timing for Coverage

Placing coverage is a two-part process:

- Initial Non-Binding Indication
- This occurs one week from 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.
- Costs nothing
- Underwriting
- \$30,000–\$50,000 upfront "diligence fee"
- Underwriters and their counsel are granted access to the data room and begin reviewing the diligence.
- Involves a two-to-three hour diligence call with underwriters, deal team members, and third-party diligence providers
- Takes one week but is dependent on the timing of the deal process. It doesn't make sense to start underwriting before the diligence is mostly complete and a draft disclosure letter has been produced.

5. How Pricing is Determined

- Risk Retention: This is expressed as a percentage of overall transaction size. The minimum is 1% of the transaction, meaning a \$100 million transaction has a minimum \$1 million retention. This can be in the form of a seller's escrow, the buyer's deductible, or a combination of the two.
- Premium: This is expressed as a percentage of the limit of coverage bought and is not related to transaction size. Currently, premiums are ranging from 2.5%–3.5% of the limit of coverage. For example, a \$10 million limit would mean a \$250,000–\$350,000 one-time payment for a six-year policy. It's worth noting that currently minimum premiums are running around \$150,000–\$200,000, so we generally don't recommend this product if the insured is seeking less than \$5 million of coverage.

For more information, see our blog post, ["Reps and Warranties—Who Pays for What?"](#)

STATE OF THE MARKET

We have seen heavy competition in 2018 that we believe has kept rates low, in spite of rising claims. As competition remains fierce, we expect to see that trend continue into next year and the pressure on retentions to increase.

We also expect to see continued pressure on the amount of diligence provided to underwriters. We have moved from full diligence reports to "red flag" style reports in the last year. We expect there to be a greater dependence on the underwriting call rather than the written diligence.

3 Main R&W Exclusions

R&W insurance is continually evolving. There are three buckets of exclusions you generally find in a policy. We have seen a shift in 2018 to push back hard on some the standard ones, with good results. Here we discuss the main types of policy exclusions and the trends we're seeing.

1. Conduct/Behavior Exclusions

The buyer is required to sign a "no claims" declaration at the start of a policy, and 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: it's worth noting that if a buyer is the insured, they are protected against any fraud by the seller, but not 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 key 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, further diligence proves this to be an isolated incident. It would be reasonable for that piece of litigation specifically to be excluded, 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

This has 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.

Wage and Hour

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

Forward-Looking Warranties

While this still 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 remains a standard exclusion.

3. Deal-Specific Exclusions

As the name suggests, this refers to specific known issues or problems inherent to the industry which underwriters will not accept liability for, 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, with us, the kind of breaches you are most likely to have—whether its intellectual property, cyber concerns or environmental—in order to make sure your organization focuses their diligence to aid in removing those exclusions from the policy.

In summary, while the type of exclusions remain unchanged in the past few years, we are now seeing that underwriters have increasing flexibility to underwrite at a higher level of granularity and take on some additional risks in these areas. This is, in part, a response to a shift in attitude, forcing underwriters to justify why an exclusion should be in the policy rather than leave the onus on the client/broker to prove why it should not. We expect to see this continue into 2019.

Structuring Your Program In Different Ways

We've talked about standard retentions and premiums, but what if you want something a little different?

High Retention/Deductible

You can certainly save serious premium dollars if you are willing to take a much higher deductible. In certain tech deals where IP was a major concern we have found a willingness by the seller to have a high-cash deductible for a limited period of time. Even if it's only for a year, a higher deductible will save a considerable amount of premium.

Fundamentals Only

Fundamental warranties are a little different from general warranties. On the simplest level, they cover ownership and ability to sell. In other words, a breach of fundamental warranties would likely result in a catastrophic/total loss as the buyer has bought something the seller was not legally entitled to sell. However, these are rarely breached and usually well documented during the due diligence phase. As a result, coverage for only the fundamentals is substantially less expensive. Insureds typically use this approach when they are comfortable with the general representations but require certainty with the fundamentals.

We have seen a trend to include a number of items within fundamentals, such as IP, employee matters, tax, etc. This changes the nature of the risk and broadens it considerably. The price savings will be greatly reduced as a result.

Time Escrows

Another way to save substantially on premium is through the concept of the time escrow. In this case, you structure the deal with a 10% cash escrow, which is returned after 12 months. The insurance is structured to only kick in a year later, once the cash escrow has been returned. Any claims pending against the escrow will be excluded from the policy, but it's a way of maintaining the value of the escrow while giving relief to the seller at lower premiums.

Choosing Limits

One question we often hear is: "How much do people generally buy?" The answer to that varies greatly, depending on the size and nature of the deal. We also look at the question, "What's the smallest amount of coverage that makes sense" and will that change?

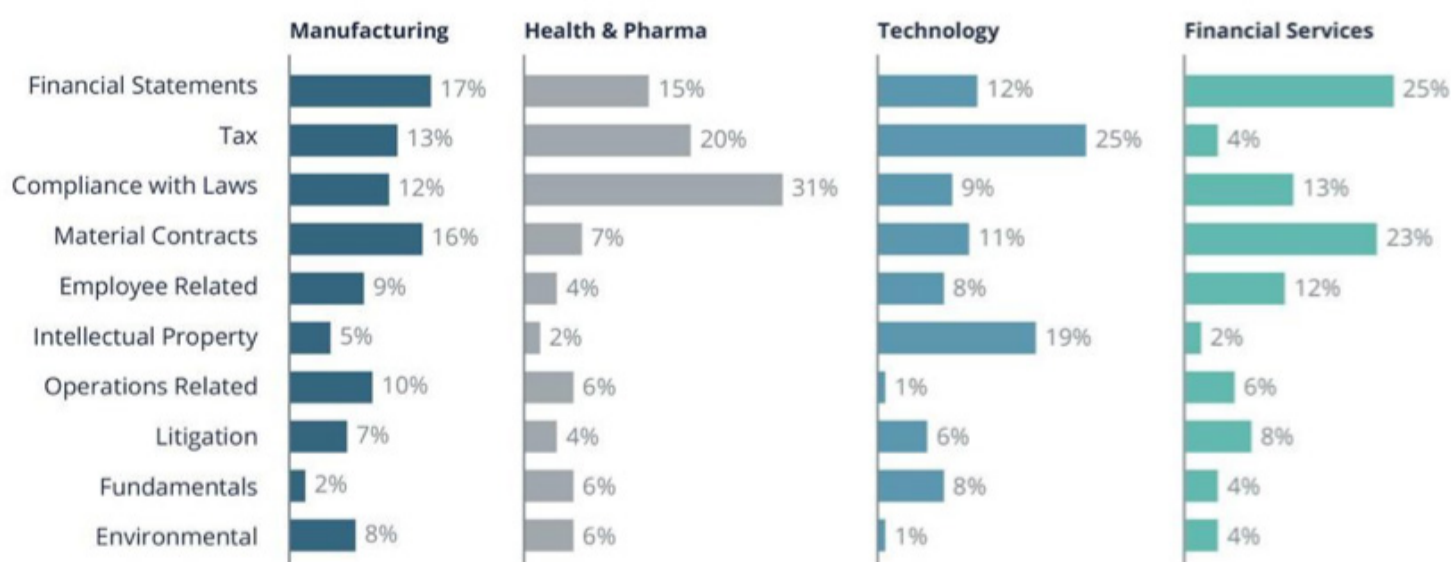
Currently, the average limit of insurance is roughly 12% of the overall transaction size. So, in a \$100 million transaction, a \$12 million limit would be the average. However, statistics can oversimplify and the purchased limit varies from deal to deal.

There are two things to consider:

1. **The Nature of The Deal:** In a standard deal, the 10% rule is reasonable. The choice of a limit is often determined by what the buyer would have considered an ideal escrow amount. This is not the case, for instance, in an IP-heavy technology deal where a failure of the IP representation could decimate the value of the entire transaction. Such reps are often considered fundamental and a much higher percentage limit may be sought to reflect this higher level of potential damage.
2. **The Size of The Deal:** If a deal is on the larger end (over \$750 million), it's entirely possible that the insured amount may be smaller than 10%, because even 5% still represents a large enough dollar amount to be material to any likely breach.

Deciding upon the appropriate limit is based on the specifics of your deal; there is no one-size-fits-all answer. This is another good reason to make sure your broker has experience with a broad range of deal sizes and industries.

R&W Reported Incidents by Breach Type and Industry



Choosing a Specialty Broker

R&W Insurance has been around in various forms for a number of years, both in Europe and the US. However, in the last three-to-four years, we have seen a major shift in its use and in its format. It is essentially an emerging product.

This is true both in terms of the product itself and the markets that write it. Two years ago there were six long-term stable markets that wrote R&W in the United States. Today there are 24 and each market is different. Some are staffed by former M&A lawyers, some by former private equity professionals, and some by CPAs. Many of these people are brand new to insurance and have varying degrees of understanding and experience. The size of the teams vary greatly, and so does the commitment from carriers.

What to Look For... and Watch Out For

Make sure your broker has a good sense of:

- The members of your team and their familiarity with insurance
- Whether the underwriter is a managing general agency
- How committed the underwriter to this space
- How claims are handled and the kind of experience the underwriter has with claims to date

In order to help you pick the most appropriate market for your risk, it's important to remember that some of this applies to brokers as well. Many brokers are new to this product and do not have tenured relationships with the underwriting markets or depth of experience with the product.

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

Here at Woodruff Sawyer, we believe that clients are best served by a team that is dedicated to Reps & Warranties day in and day out, with access to broader resources that can review all of your organization's insurance needs and present a holistic solution.

Reps & Warranties insurance is a complex and fast growing marketplace. It requires a dedicated insurance broker who understands not only this type of coverage, but is backed by the resources to handle all the in-surance lines and questions that come out of a transaction.

Questions or Comments About This Guide?

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