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Risk Insights

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Representation and Warranty Insurance

Mergers and acquisitions are common tools for many organizations. While important for continued growth, mergers and acquisitions can open organizations up to a variety of transactional risks, particularly if a statement made by a seller in a purchase and sale agreement turns out to be false. This often occurs as unintentional breaches of representations and warranties that are discovered after a deal is closed.

To protect against these transactional risks, an increasing number of organizations are turning to representation and warranty insurance (RWI).

What Is RWI?

RWI is a form of insurance designed to guarantee the contractual representations made by sellers associated with corporate mergers and acquisitions. Put another way, once a merger or acquisition deal has been finalized, RWI can cover the unforeseen costs caused by any breaches of the seller's representations.

RWI is used to shift certain transaction-related risks from buyers or sellers to a third-party insurer. In general, RWI can protect both buyers and sellers against losses suffered from breaches of the representations and warranties contained in a purchase and sale agreement. Often, RWI can replace or supplement the indemnity contained in such agreements.

What's more, a key benefit of RWI is that is that it provides an alternative to escrow funds, which have traditionally been used to satisfy claims associated with representations and warranties contained in merger and acquisition agreements.

To better understand the application of RWI, it's important to have a sense of common buyer and seller goals during a merger or acquisition:

- Buyers—During a negotiation, buyers typically want to protect their investment as much as possible by doing their due diligence, seeking broader representations and warranties, requesting more comprehensive indemnities, and requiring larger escrows and holdbacks.
- Sellers—Sellers will often look to make as clean of a break as possible, seeking to reduce their transaction indemnity profile risks. As such, sellers tend to want fewer and narrower representations and warranties (with shorter survival periods). In addition, sellers typically request limited indemnities and smaller (or no) escrows and holdbacks.

Because of these unique goals, there's often a disconnect between buyers and sellers, with neither wanting to accept more risk than is necessary. RWI is often used to facilitate deals, providing both buyers and sellers more flexibility and peace of mind when it comes to risk allocation. As such, RWI is especially useful in the following kinds of transactions:

- Transactions in which a buyer is concerned that it would have no recourse should a seller become bankrupt in the future
- Competitive auctions where sellers need RWI as part of the bid submission process or bidders need RWI to stand out from other offers
- Time-sensitive transactions, particularly where RWI can reduce the length of allocation negotiations.
- Instances where indemnity right enforcement can be a challenge, like in cross-border deals
- Instances where sellers wish to have a clean exit without holdback and provide the highest payout to investors at closing
- Instances where sellers will have a continued relationship with the buyer after the deal is finalized

Key Aspects of RWI

Because RWI is not a standard policy, it can vary from organization to organization. However, many policies contain the following characteristics:

1. Coverage—In general, RWI policies are tailored per transaction and can be purchased by both buyers and sellers. It's not uncommon for RWI policies to provide blanket coverage for breaches of the seller's representations and warranties found in a purchase and sale agreement. In some instances, a party may purchase RWI without the consent or knowledge of the other entity involved in the deal.
2. Retention and deductible—RWI will often contain a self-insured retention or deductible. These will vary between transactions based on an insurer's risk assessment, but typically fall between 1% and 3% of the total value of the transaction.
3. Duration of coverage—Policyholders can negotiate the duration of coverage. However, insurance will typically match the survival period of the representations and warranties found in the purchase and sale agreement. You may extend coverage as needed.
4. Coverage limits—Limits will vary between policies, but can be as high as $50 million. Limits can be set based on any negotiated escrow or indemnification limits under the purchase and sale agreement.
5. Pricing—Pricing of RWI policies depends on the nature of the insured risks, the amount of the retention, the length of the coverage and the coverage limit.

It's important to note that RWI policies often contain a number of exclusions. Generally, RWI policies do not offer protection for known issues and any breach of a representation or warranty (particularly when any member of the deal team has knowledge of the breach at the time the policy's coverage begins). Policies may also have exclusions specific to the transactional risks insurers aren't willing to cover.

Benefits of RWI for Both Buyers and Sellers

While the majority of policies are written buy-side, both buyers and sellers can benefit from RWI. Those benefits are as follows.

Reasons for Buyers to Purchase RWI:

1. RWI offers protection for losses due to breaches of warranties or claims on indemnities.
2. RWI helps buyers recover losses directly from a financially secure insurer instead of a seller that may or may not have the assets to satisfy a claim. This also improves buyer confidence, as RWI allows for low-risk mergers and acquisitions.
3. RWI extends the duration for representations and warranties. This can help buyers identify and report problems with the acquired business and seek reimbursement.
4. RWI can distinguish a bid in a competitive auction. This, in turn, enables a bidder to accept more risk and can reduce or eliminate the need for a holdback or escrow account.

Reasons for Sellers to Purchase RWI:

1. RWI offers liability protection, particularly for defense or settlement costs.
2. RWI allows sellers to distribute sale proceeds fully rather than tying up funds in an escrow account.
3. RWI can protect passive sellers (individuals who have not been actively involved in the management of the business) from unintentional nondisclosures or breaches of representations.
4. In the event of a dispute, sellers are not responsible for the cost or complexity of defending a claim. This responsibility instead falls on the insurer.

Getting Started With RWI

Those interested in purchasing an RWI policy should consult with a legal advisor as well as a qualified insurance broker. Contact Bryson Financial today to learn more.
