

M&A Representation & Warranty Insurance Trends

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Representation and warranty insurance (“R&W Insurance”) is a risk-mitigation tool used with increasing frequency in the world of mergers and acquisitions. Put simply, R&W Insurance allows parties engaged in the sale of a company to “insure” against any damages caused by a breach of a representation and warranty under the governing purchase agreement. At this time, R&W Insurance is primarily gaining acceptance with respect to unknown or unknowable liabilities of potential sellers.

In deciding whether R&W Insurance is appropriate for a specific transaction, potential buyers and sellers should consider the following:

Will the Insurer Actually Cover Losses?

- Market forces make it difficult for insurance companies to deny valid claims. The potential claims are highly vetted prior to the issuance of the policy (unlike in a traditional insurance setting), and only about 1 in 5 deals will have a claim submitted. If the insurance companies did not pay out valid claims, the business would dry up.

Increased Due Diligence Requirements

- The purchase of R&W Insurance can increase the rigor of the due diligence process. As a third party insurance company will be assuming the liability created by any breach of a representation and warranty, the insurer will need to attain a certain level of comfort prior to issuing a policy. While insurance companies tend to piggy-back off of the diligence completed by the transaction parties, they will often require highly detailed diligence reports.
- In order to ensure closing is not delayed, insurance companies suggest that any request for R&W insurance be provided 2-3 weeks prior to closing (though any request should be placed after the conclusion of the initial round of legal and financial diligence in order to fully expedite the insurance process).

Inability to “Rep Away” Concerning Issues

- At times, when a potential buyer uncovers a concerning issue during the diligence process, a seller may agree to “rep away” the concern—or, put another way, agree to indemnify the buyer for any damages arising from that concern post-closing. In transactions involving R&W Insurance “repping away” concerns is often no longer an option as insurers are hesitant to assume the associated risk. In these circumstances, the sellers may need to provide a special indemnity.

Key Policy Concerns

- As is the case with all insurance contracts, the primary concern in evaluating the policy itself is the definition of “loss”, as this will determine the damages a buyer is entitled to in the instance of a breach. Certain definitions of “loss” may provide that a buyer is only entitled to out-of-pocket costs in the event of a breach while other definitions may provide that the buyer is entitled to any additional loss in value caused by a faulty representation or

warranty (i.e. the total difference between the actual value of the purchased company and the value of the company had all representations and warranties been true).

- Additional concerns may include the scope of the “knowledge” definition under the policy (i.e. actual v. constructive knowledge) and whether the policy permits sandbagging or anti-sandbagging clauses (most policies do not allow for this language).

Who Should Consider R&W Insurance?

- R&W Insurance is often appropriate for transactions with well-organized sellers and savvy diligence oriented buyers.
- Private equity players may also wish to consider offering R&W Insurance as a “market differentiator” in a competitive bidding process. Additionally, as private equity buyers will often retain former owners in a management role, having R&W Insurance will allow a private equity buyer to avoid the awkward situation “suing” its management team in the event of a material breach of a representation or warranty.

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