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**Please note: The following article is one of several featured in this issue.**

# Representations and Warranties Insurance: No Longer Optional for Strategic Buyers

**By Stephen Leitzell, Partner of Dechert LLP**

For well more than a decade now, lawyers and clients active in the private equity space have used representations and warranties insurance ("RWI") as a key tool in their deal-making arsenal. As the market for RWI has grown and matured, M&A practitioners have recognized its utility in bridging the fundamental expectations gap between buyers and sellers regarding post-closing recourse. In the summer of 2015, Dechert, along with Marsh USA published a report entitled "Representation and Warranty Insurance: No Longer Optional,"[1] which described the great expansion in the market for RWI that was then underway. Today, RWI is not only "no longer optional" for private equity buyers, but for strategic buyers as well.

It is our experience that in today's market, most private equity buyers will start from the premise that they will utilize RWI in all of their deals, and use that knowledge and experience to try and gain a competitive advantage over other potential buyers. Buyers will do this by highlighting for sellers in indications of interest and letters of intent that they will in most cases only have limited post-closing recourse and rely primarily on RWI. Quite simply, in a competitive market for targets, they use it as a selling point to make their bid more attractive to sellers.

On the other hand, strategic buyers, roughly defined as buyers using M&A as a strategy to supplement the growth of their underlying businesses, in our experience have only in the last several years begun to use RWI in their deals with more frequency. This anecdotal experience is supported by the most recent ABA Private Target Deal Points Study, which showed that

1 See "*Representation and Warranty Insurance: No Longer Optional*" published by Dechert LLP and Marsh USA Inc., July 9, 2015, available at https://www.dechert.com/knowledge/publication/2015/7/representation-and-warranty-insurance-no-longer-optional.html.

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in 2018-2019, private transaction agreements referred to RWI in 52% of cases, an increase from only 29% of agreements in the 2016-2017 period.[2]

This article will explore the reasons that strategic buyers have only more recently begun to make use of RWI in their transactions, both on the buy-side and the sell-side, and will also discuss certain issues that often arise when negotiating over the use of RWI in strategic M&A transactions.

## Overview of RWI

RWI generally functions as a substitute for a portion or all of a seller's indemnification obligations for breaches of representations and warranties in an M&A transaction. RWI policies usually do not cover losses for breaches of covenants (other than with respect to pre-closing tax indemnification), or purchase price adjustments.

A typical RWI policy will cover the insured's losses over a specified deductible, which is called a "retention amount" in RWI terminology (i.e., coverage is not available for the first dollars of loss). The retention amount is often 1% of the total transaction value, but can be more or less depending on various factors. In most policies, the retention amount is reduced after a specified period of time. This "retention drop-down" is fairly commonplace. We typically see the drop-down between the 12- and 18-month anniversary of the closing of the transaction.

This drop-down generally (but not always) aligns with the expiration of the general survival period for representations and warranties in the underlying acquisition agreement. In some cases, the seller will share in at least a portion of the retention amount for 12 to 18 months, demonstrating that the seller has some "skin in the game," in order to mitigate the moral hazard inherent in insuring a third party's representations and warranties. The relatively small exposure of the seller in these scenarios has resulted in significantly lower amounts, if any, to be placed into indemnification escrow accounts. Escrows traditionally ensured that the seller would have liquid funds available to satisfy indemnification claims.

In transactions with RWI policies, escrows often serve that purpose only for the seller's portion of the retention amount or, where specific liabilities have been identified — which are typically excluded from coverage of an RWI policy — to be a backstop for losses caused by those liabilities. However, the market has increasingly provided insurance in public-style/no indemnity deals. In those situations, the buyer bears the burden of the entire retention amount.

The losses covered by RWI policies are subject to a specified coverage limit, which is set by the insured (with the approval of the underwriter) and reflects the insured's risk appetite. The coverage limit is the threshold up to which the insured is willing to pay for coverage and above which the insured either "self-insures" or obtains recourse — mainly for fundamental representations — against the seller.

## Why Have Strategics Arrived Later to the Party?

While RWI is now a standard part of deals for most private equity buyers, strategic buyers as a general matter were slower than financial buyers to use the product, and in many cases are just gaining their first experience with RWI. Why is that?

Primarily, strategics have been late to the party because for years they did not need to use RWI

2 See *2019 ABA Private Target Mergers & Acquisitions Deal Points Study,* at 116. Since this study relies on publicly available acquisition agreements for private deals, it is a reasonable assumption that the vast majority of the surveyed deals are with strategic (and public) and not financial buyers.

to meet their M&A business objectives. First and foremost, most strategics are much more often buyers than sellers. While they will occasionally divest of non-core or underperforming assets, M&A is a key part of the growth strategy for many businesses, and their M&A experience is much more typically on the buy-side of transactions. As such, dealmakers at strategic buyers are very familiar with the traditional seller-indemnification structure and take comfort in having post-closing recourse against sellers who are "standing behind" the representations and warranties that the buyer will rely on.

In private deals at least, and particularly in strategic-to-strategic carve-out deals, the seller typically has a meaningful balance sheet and can stand behind any lingering indemnity obligations; if it cannot, escrows support these obligations instead. So, with the familiarity and comfort of this traditional structure, there was very little reason from their perspective to change it. Using RWI also meant bringing a third party into the negotiation and possibly slowing things down, paying underwriting fees to the carrier and likely expanding the due diligence review beyond their typical scope. Consequently, it did not seem necessary or worth the additional effort.

The situation remained this way for years because more often than not, there was no real pressure to do anything differently. Large strategic acquirers looking for targets in their own industry often have inherent advantages with which private equity firms and other financial buyers often struggle to compete. As assets come to market, strategic acquirers are often the most logical recipients of the first call, either from the targets themselves or from strategic relationships at the investment banking firms that bring those businesses to market. They are not only the first buyer one often thinks of, but they can often pay the most due to their ability to leverage synergies with their existing businesses and fold the target into their existing corporate overhead structure.

Strategic buyers also have advantages in financing, in that they usually have the ability to quickly finance deals by using cash off the balance sheet, borrowing using existing revolver capacity or, in the case of public companies, using their stock as currency. Therefore, in many cases, strategic buyers had the negotiating leverage to insist upon the terms that they would require, which traditionally included representations that survived for a period of time after closing, with seller post-closing indemnification if those representations turned out not to be true.

This was often the case regardless of whether an acquisition was the result of a one-on-one negotiation between the parties, or if a business was brought to market by a banker in an auction. Strategic buyers often had the ability to pre-empt an auction and demand exclusivity, and sellers often capitulated, granting exclusivity based on the fact that the strategic buyer was willing and able to pay a significantly higher price than other bidders due to the inherent advantages discussed above.

But that negotiating leverage has changed as the M&A market has stayed hot in recent years, and the RWI market has continued to mature and become more efficient and easier to access. Sellers of businesses, familiar with the product through their own buy-side activity, whether as strategic sellers or private equity owners themselves, have increasingly taken the view that they will only sell to a buyer willing to use RWI in

order to eliminate or at least minimize their post-closing exposure.

Strategic buyers who in previous auctions would scoff at the notion of using RWI now have no choice if they want to be the winner of the auction and get the prize. The M&A market is robust enough, and there is enough money out there chasing deals, that sellers have had more ability to negotiate terms.  So strategic buyers who want to be able to continue an active M&A strategy have had to be more open to using the product, or risk missing out on opportunities.

Additionally, circumstances from time to time have come up where RWI is the only way for a strategic buyer to receive any meaningful post-closing indemnity coverage, such as in distressed situations or when buying a business owned by an ESOP when indemnification outside of any escrow is otherwise not available.

The data backs up this anecdotal experience as well. SRS Acquiom, in their analysis of private target M&A transactions between January 1, 2018 and June 30, 2020, measures what they call the "Buyer Power Ratio," which divides the market capitalization of a public company buyer against the purchase price for any acquisition to try and measure the parties' relative negotiating strength and ability to obtain favorable deal terms.[3] The higher the Buyer Power Ratio, the more likely the buyer is able to impose its will in negotiations with the seller. In their study, SRS Acquiom noted that:

> "In deals where the buyer is a publicly traded company, Buyer Power Ratio ("BPR") continues to be the greatest indicator of whether Buy-Side RWI will be purchased on a particular deal. Transactions with public-company buyers without RWI show a wide range of BPR values, while transactions with public-company buyers that use Buy-Side RWI have low BPR values, which typically correlate with less divergent relative negotiating strengths between the buyer and the sellers."[4]

Stated another way, while the biggest companies probably still have the ability to set terms, the closer the relative bargaining power between the buyer and the seller in any deal, the more likely that the seller will require RWI in order to limit its post-closing exposure, and the more likely that the buyer will have to agree. As this reality has become more apparent in recent years, strategic acquirers have had to become more familiar and comfortable with using RWI as an integral part of their transactions, which has also been our experience representing strategic acquirers over the last several years.

Similarly, having often become familiar with RWI through their experiences on the buy-side, strategic sellers of businesses have increasingly prepared auction drafts based on the assumption that any buyer will have to incorporate the use of RWI into its bid to be successful. From the sell-side perspective, strategics, like any sellers, see the obvious benefit of limiting their post-closing

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3 SRS Acquiom, *September 2020 Buy-Side Representations and Warranties Insurance (RWI) Deal Terms Update*, at 6.
4 *Id*. at 12.

exposure, coupled with the ability in most cases to push the cost and effort of obtaining third-party insurance coverage onto the buyer.

If the purpose of a strategic disposition is to allow the remaining business to focus its efforts on its core competency, a sale transaction where the buyer's post-closing recourse is solely or primarily against the insurance policy and not against the seller's remaining business is the quickest way to get the "clean break" that is typically an objective of any such sale transaction.

Yet another benefit to using RWI in strategic transactions is that it has the potential to keep the parties on more "friendly" terms, even after a deal that results in a post-closing indemnification claim. Often, these transactions are between participants in the same industry who know each other and may be both competitors and colleagues, or have ongoing commercial relationships, such as supply or customer agreements.

Deal participants may continue to see one another at industry conferences and in other contexts outside of the M&A world. A lingering dispute over an indemnity claim between the parties is a sure way to sour that relationship. The use of RWI, however, can put a third party between a buyer and a seller who have to continue to work with one another in other contexts, potentially preserving a valuable business relationship for the parties.

## Familiarizing Strategic Buyers on the RWI Process

In our experience for strategic acquirers on the buy-side, the two primary considerations the first time they consider a transaction with RWI are cost and timing. Logic dictates that adding any third party to a negotiation will always add time and complexity to the process. Fortunately, while RWI may be new to many members of the M&A deal team, most strategic clients have internal lawyers who are very familiar with insurance markets and processes generally, as they are responsible for the entire insurance program for the organization as a whole.

These individuals speak the language of insurance and know the meaning of terms like retentions, exclusions, etc., and they typically have a primary contact at the insurance broker they use who is usually a trusted advisor to the company. The key in our experience is to get this individual involved as early in the process as possible to begin to survey the market and solicit bids from the insurers. This step goes a long way toward getting the deal team sufficiently comfortable that it makes sense to go down this path, and that the use of RWI will not jeopardize or slow down their deal.

From a cost perspective, clients take comfort knowing that there is a competitive market for the product and insurers will be bidding against each other on pricing. It is important that the client begin to consider the cost of RWI as just another transaction expense that is necessary to get the deal done. And on timing, the broker will (hopefully) echo what the lawyers are advising: that the policy can be completed and bound in the time otherwise allotted to get to signing. The insurers are well aware that they need to move at "deal speed" or they will not be long for this market.

The other aspect of a deal with RWI that may be different from the client's prior experiences is that the due diligence process may have to

be conducted differently than had RWI not been used. Many strategic clients are extremely well experienced in how to conduct due diligence on targets in their industry. They know all of the issues and have the internal resources necessary to review most aspects of a target's operations without needing very much in terms of outside support. They may ask the outside lawyers to review certain contracts in the data room, or they may not, it just depends on the client and the deal. However, with a third-party insurer at the table, due diligence needs to be conducted somewhat differently.

A third-party legal due diligence memo will need to be prepared by counsel to the buyer, which the insurer and their counsel can then review. This involves having the buyer's counsel review everything or almost everything a target makes available in the data room and preparing at least a summary level due diligence report, which inevitably is going to take time and result in increased legal fees. Insurers will also want to review any other third-party report the buyer commissions, including quality of earnings or tax diligence reports from accounting advisors.

In our experience, it is helpful to have a discussion early in the process with the broker and insurer regarding the extent of due diligence the buyer intends to undertake internally, so, for example, if the buyer does not intend to engage a third party for a quality of earnings review, the buyer can prepare whatever internal work product is necessary to get the insurer comfortable. Finally, the insurers will also want to have one or more due diligence calls with the buyer's deal team to go over the due diligence that has been done, and review in more detail any issues that have been surfaced.

What is most helpful for clients in our experience has been to map out the entire process at the beginning when RWI is first used, so that clients have a good understanding of the process and timing (and comfort that this process will not slow down their deal). So, while there may be extra layers of work and cost, we have found that ultimately buyers find value in the process. Usually, the extra work and cost is seen as a small price to pay for the coverage they are buying after the deal concludes, which in most cases will last longer than the survival period that would have otherwise been negotiated with the seller and will provide access to a deeper, more reliable pocket to pursue in the event there actually is a claim.

## Post-Closing Recourse Against Sellers in Strategic RWI Deals

There are several key issues that need to be negotiated regarding the extent of any post-closing recourse from the seller if the representations and warranties are breached. Of course, the seller will start from the position that the only post-closing recourse available should be from the policy, that RWI should be the buyer's sole and exclusive remedy for indemnification claims and that they are proposing a "clean walk-away" public company style deal.

From the buyer's perspective, even in RWI deals it is important to convey to the seller that this expectation is unrealistic and not the norm. Buyers and insurers alike will prefer, and sometimes require, sellers to be responsible for at least a portion of the retention amount under the policy for some period of time, demonstrating that the seller has some "skin in the game" in order to try and mitigate the moral hazard

inherent in insuring a third party's representations and warranties.

To further address the moral hazard problem insurers will often ask in underwriting calls about the history and scope of the negotiations over the purchase agreement, presumably to confirm that the seller took an active role in the negotiations of the representations and warranties and the preparation of the disclosure schedules. Additionally, buyers will often require a stand-alone indemnity from the seller for any matters that the insurer insists on excluding from the policy. This could include any matters that are known at the time of signing and are disclosed on the disclosure schedules.

Another consideration is that unlike a public company transaction or for that matter most private equity transactions, strategic deals are often structured as asset sales. In an asset deal, in addition to breaches of the representations and warranties, sellers will typically indemnify the buyer against any excluded liabilities and liabilities relating to any retained assets. These indemnities have to remain seller obligations because it would be unfair to the buyer in an asset deal to have potential exposure to liabilities that it did not agree to take on and that have no relation to the business it is buying.

With the possible exception of the pre-closing tax indemnity, third-party insurers are only going to cover breaches of the representations and warranties in the purchase agreement, so sellers in asset deals will have to remain responsible and indemnify buyers against these items as is typical in any asset purchase.

The most recent ABA Private Target Deal Points Study found that in 2018-2019, only 14% of the transactions that referenced RWI provided that RWI was the buyer's sole source of recovery for breaches of representations, down from 23% of the deals surveyed from 2016-2017.[5] Clearly, then, the vast majority of strategic transactions with RWI maintain some post-closing recourse against the seller.

Once the sole and exclusive remedy hurdle has been cleared, the discussion usually then centers on which representations will "survive" the closing. In the context of a transaction using RWI, survival is the code word for the buyer being able to make an indemnification claim against the seller for breach of a specific representation or warranty for some agreed upon period of time after the closing, as opposed to the sole remedy for seller breaches being for the buyer to make a claim against the policy.

A true public company style deal where there is no recourse after closing against the seller itself is, as a general matter, not practical from the buyer's perspective in private transactions.

This is because, among other reasons, insuring the entire purchase price is cost-prohibitive, yet if a representation such as title or authority is breached and the entire business is not conveyed, the buyer will be left without a complete remedy (other than perhaps a fraud claim).

The solution to that issue that has emerged in the market in RWI deals is that the so-called "fundamental" representations survive, allowing claims for breaches of those representations to

5 See *2019 ABA Private Target Mergers & Acquisitions Deal Points Study,* at 119.

be made against the seller, with some negotiating to be done between the parties as to which representations will be considered "fundamental." In this construct, claims typically can be brought against the seller for the full amount of any damages resulting from a breach of any fundamental representation up to in most cases the purchase price.

Most parties will agree that representations and warranties concerning organization, authority, title to all of the stock of the target or its subsidiaries and brokers are truly "fundamental" to any transaction, and that whether there is RWI or not, the seller should stand behind these representations and be responsible for the full amount of any damages resulting from any breach. Otherwise, the buyer argues that it cannot be sure it is getting what it thinks it is buying, and the seller should be willing to cover the buyer if there are any deficiencies in these areas (which there never should be).

The more interesting discussion occurs when the negotiation moves to the title to assets and sufficiency of assets representations, particularly in any transaction that can be considered a "carve-out" from a larger entity. So called "carve-outs" are very common in strategic-to-strategic deals where businesses are often "carved out" of, or broken off from, a larger organization, after the seller has determined for whatever reason that the business it is divesting is no longer core to its mission or business objectives.

This is a primary acquisition and growth strategy for many strategic clients, investing in businesses, business lines or brands that may have been neglected or not prioritized within the organization of a larger parent entity. But in carve-out deals, the title and sufficiency of assets representations are in fact usually the most fundamental, because they provide coverage to the buyer that the seller is actually conveying to the buyer the entire business upon which the purchase price has been determined.

For example, the typical representation that the seller might provide to the buyer in such a situation is as follows:

> Seller has good, valid and marketable title to, or a valid and enforceable leasehold interest in, the Purchased Assets in each case, free and clear of all Encumbrances other than Permitted Encumbrances, and the Purchased Assets, along with the assets and services contemplated to be provided to Buyer pursuant to the Transition Services Agreement, comprise all of the rights, property, and assets utilized by Seller and its Affiliates in the operation of the Business and are sufficient to permit Buyer to manufacture and sell the current products of the Business in a manner substantially consistent with the manner in which the current products of the Business are manufactured and sold by Seller and its Affiliates before the Closing and otherwise operate the Business as currently conducted.

The seller might look at this representation and think that there could be many ways this representation could be breached. Carve-outs are complicated and there might very well be a situation where an asset does not convey to the buyer that was needed for the business, and this is what RWI is for, to cover the buyer for small things that may have been overlooked.

However, from the perspective of the buyer, recourse only against the insurer for breach of this representation may not be sufficient.

The buyer will ask the seller, what if you only transfer to me half the business? What if you forget to sell me the part of the business that makes the key component to the product? Or fail to convey with the business the contract from a key supplier or distributor? Recourse against the policy may not solve the problem if the coverage under the policy is only 10 or 20% of the purchase price; this is not an exposure that thoughtful buyers should accept. Therefore, in order to ensure that the buyer is getting what it thinks it is buying, or has recourse against the seller if it does not, it is fair for this representation to be considered fundamental in carve-out deals, and for buyers to have recourse against the seller in cases where this representation is breached.

The seller might look at the outcome of the hypothetical negotiation described above and wonder if it is really getting the "clean walk-away" it hoped for if it is still on the hook for every desk and chair in the office that it thought it owned, but turned out to not. This is where the allocation of responsibility between the seller and the insurer and the priority of claims becomes the important point in the negotiation from the seller's perspective.

In particular, the seller should negotiate for a position that provides that with the possible exception of one half of the amount of the retention on the policy (which may be placed into escrow), the buyer must proceed against the RWI policy in the first instance with respect to a breach of any fundamental representation, and only then proceed against the seller if the coverage is exhausted or recovery cannot be made against the policy for any reason. This negotiation will likely include a discussion of the buyer's efforts standard and duty to mitigate its damages, and just how far it should have to go, including an obligation to bring a lawsuit against the insurer to enforce the terms of the policy before recovery from the RWI is considered exhausted.

From the seller's standpoint, the important point to memorialize is that in the case of fundamental representations, the RWI is the source of recovery in the first instance and recovery against the seller is only available as a backstop for coverage in case the primary layer (or layers in case of a stack of coverage) is not available. In practice, this is a common outcome, as the ABA Private Target Deal Points Study found that in 58% of transactions using RWI from 2018-2019, buyers were required to first pursue claims against the RWI policy before proceeding against the seller.[6]

It is also worth noting that no two acquisitions are ever exactly the same, and we have also seen strategic transactions with negotiated hybrid approaches where certain representations that typically would not be considered fundamental survive for some period of time while subject to a specific basket and cap typical for a more traditional indemnification structure. For instance, this hybrid structure has been used in healthcare transactions, as buyers of healthcare businesses are often acutely aware of potentially significant liabilities that they could possibly inherit for healthcare-related fraud and other reimbursement related matters.

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6 *Id*. at 120.

In certain circumstances, insurers may attempt to exclude healthcare-related representations from coverage, although that has generally not been our experience in recent transactions. For a concerned buyer, limiting potential recovery to the policy limit for healthcare-related breaches may not be comfortable. We have found in those cases that a hybrid approach that involves a shorter survival period for the healthcare representations than the fundamental representations (such as two or three years) and a cap that may be higher than the policy limit but less than the total purchase price might be an appropriate framework to bridge the gap between the parties. That being said, sellers will be keen to still require the buyer to proceed against the policy first, and only make a claim against the seller in cases where coverage under the policy is not available.

## Looking Forward

While not a new product generally, our recent experience is that RWI has emerged in the past few years as a critical tool for both strategic buyers and sellers in executing M&A transactions, as it has been for private equity buyers for many years. As strategic acquirers have become more familiar and comfortable with the product and how it works, they have seen the versatility it provides in helping to bridge the gaps between buyers and sellers to complete transactions.

Buyers appreciate the source of recovery RWI provides, while sellers appreciate being able to complete transactions while eliminating or significantly limiting the lingering overhead of possible exposure. For these reasons we expect to continue to see RWI be a part of the deal-making landscape for strategic transactions for years to come.

FOUNDING PUBLISHER - Jesse M. Brill, J.D. Yale Law School
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