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What's market in transactional insurance?

By Louis Lehot, Esq., and Eric Chow, Esq., Foley & Lardner LLP

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Over the past decade, we have watched Representations & Warranties (RWI) insurance policies play an increasingly critical role in mergers & acquisitions (M&A), whether the buyer is a financial sponsor or a large public company, and everything in between.

RWI policies address potential post-closing liabilities and provide significant peace of mind for both buyers and sellers to mitigate risks, sweeten a buyer's bid, offer more cash to sellers at first closing, enhance deal certainty, externalize potential post-closing conflicts, and facilitate smoother negotiations and transactions.

What do RWI and W&I insurance policies cover?

RWI (sometimes referred to in Europe as a warranty & indemnity insurance policy or W&I) is a specialized insurance policy that is typically utilized in M&A transactions to protect against potential financial losses that can occur from breaches of the representations and warranties made by the seller in the transaction.

RWI can allow both the buyer and the seller to allocate risk of post-closing loss to a third party, allowing for smoother and faster transactions, and better relationships.

These could be misrepresentations in areas such as financial statements, taxes, protection of intellectual property, labor and employment, operational issues, or compliance with laws.

When these policies are utilized, in the event a buyer suffers a loss as a result of a breach of a representation made by the target or the seller, instead of prosecuting an indemnity against the seller, the buyer would bring this claim against the seller to a third-party insurer, thereby transferring the risk of loss from the seller to the insurer, adding a layer of protection for both parties.

By transferring the risk, they also help to eliminate a great deal of post-closing disputes. This is particularly desirable in instances where seller (or a stockholder of seller) becomes an employee of buyer, as indemnity claims against an employee would impair the employer-employee relationship and disincentivize employee retention.

They are typically subject to certain exclusions, notably for liabilities identified by the buyer in the course of its due diligence exercise.

What are the benefits of RWI policies?

RWI can allow both the buyer and the seller to allocate risk of post-closing loss to a third party, allowing for smoother and faster transactions, and better relationships. They limit the post-closing liability for the seller, as well as the need for large escrow amounts or holdbacks.

All the terms must be carefully negotiated, with policies tailored to fit the very specific needs and risks that come with every transaction.

Since seller will have limited to no exposure on potential breaches, adoption of RWI tends to speed up negotiations on the often lengthy representations and warranties in the agreement.

There is also increased financial security for buyers as they have financial recourse beyond the seller's indemnity obligations, as well as the added benefit of coverage for unknown risks that might not have been accounted for during the negotiation of escrow/holdback size if a direct indemnity was used as the primary recourse for buyer.

These policies can also be an attractive selling point, attracting more buyers. From seller's perspective, RWIs lead to the reduction or elimination of escrow/holdback, so that seller will receive the benefit of the full purchase price at closing and will not need to worry about having to make an out-of-pocket indemnity payment post-closing.

What are the current trends in RWI and W&I insurance claims?

Aon has released their 2024 Transaction Solutions Global Claims Study[1] on emerging trends in R&W claims around the world.

Some of the highlights they note in their report include:

- Payouts and losses: Through the end of 2023, RWI insurers paid more than $1 billion to Aon clients in North America, recognizing more than $1.5 billion in total loss (this includes retention amounts). More than $550 million of this was paid in the last three years.

- Time frame: More than $300 million has been paid to Aon clients on claims filed more than 12 months after the close of the transaction.
- Number of claims: 18.2% of North American policies issued between 2016-2020 have seen at least one claim made.
- Drivers of loss: Compliance with laws has now become the third most significant driver of loss. Financial statements and material contracts top the list.
- Amount of loss: 42.7% of claims paid by Aon have involved payment on greater than a dollar-for-dollar loss.

What are the legal considerations in RWI and W&I policies?

There are numerous legal issues that must be considered when contracting for an RWI policy.

First, it is important to consider the scope of the coverage and to review the policy exclusions carefully. In formulating exclusions, insurers rely on the diligence reports produced by buyer. It is imperative that buyer phrase its findings precisely and succinctly so as not to create unnecessary concerns on the insurer's part regarding non-material issues which may lead to more exclusions.

There should also be an understanding of the financial thresholds by both parties, with set policy limits that outline the maximum coverage and retention amount. Buyer and seller will need to consider (i) who should bear the risks that falls within the retention amount and (ii) whether seller will have any liability beyond the policy limit.

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When conducting its diligence and preparing its diligence report, buyer will need to ensure that they are completed at a level comprehensive enough for the insurer, and buyer should preempt and be prepared to address insurer's concerns in order to minimize exclusions and enhance effectiveness of the RWI.

These policies include a survival period, which should also be clearly defined, determining the maximum length of time after closing during which a claim can be made. There may also be an option to have tail coverage that would cover longer term liability claims after the survival period has lapsed.

While RWI policies offer tremendous benefit, they must be structured so that the coverage provides the appropriate protections and is in alignment with the risk profile of the transaction.

Due diligence may uncover liabilities during this process that can be considered a "known breach." These are generally excluded from all policies. However, some insurers may offer products that cover specific known breaches at an additional cost.

Working with an experienced and expert RWI broker to go to market to find the most expansive coverage is step one. Then, legal counsel can work with the RWI broker to review and negotiate the nonbinding indication letter, or NBIL, followed by a full policy that will bind upon closing.

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After two years where an increasing number of insurance carriers have brought new product offerings to the RWI market, while the market has seen a decreasing number of deals, experienced brokers and counsel are well positioned to help buyers and sellers negotiate maximum coverage at optimal cost.

Notes:

[1] https://aon.io/3RyHAaf

About the authors

Louis Lehot (L) is a partner with **Foley & Lardner LLP**, where he is a member of the private equity and mergers and acquisitions practices as well as the technology sector team. On the sell side, Lehot helps entrepreneurs and their management teams, investors, and financial advisers exit smartly, and on the buy side, he helps strategic and financial buyers grow. He can be reached at llehot@foley.com. **Eric Chow** (R) is also a partner with the firm and a member of the M&A team. He handles public and private mergers and acquisitions, investments, and joint ventures, as well as other corporate transactions, with a focus on technology and energy businesses. He can be reached at echow@foley.com. Both authors are based in the firm's Silicon Valley office in California.

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