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M&A Report: How Representations and Warranties Insurance Is Transforming Risk Allocation in M&A Transactions

To Our Clients and Friends:

Under a buy-side representations and warranties insurance ("RWI") policy, the buyer in an M&A transaction recovers directly from an insurer for losses arising from certain breaches of the seller's representations and warranties in the acquisition agreement. By shifting the risk of such losses from the seller to an insurer, the buyer and seller can limit or even eliminate the seller's liability for certain rep breaches, all without materially diminishing the buyer's coverage.

The Evolving RWI Market

As RWI has gained market acceptance over the last few years, a significant number of new insurers have entered the RWI market. With this increased competition, market forces have led insurers to offer improved terms to buyers seeking RWI coverage.

For instance, just a few years ago, RWI premium amounts generally ranged from 3% to 4% of coverage limits, and RWI "retention" (*i.e.*, deductible) amounts generally ranged from 1.5% to 2% of deal value. Since then, premium and retention amounts have steadily decreased. In today's market, RWI premiums are routinely below 3% of coverage limits, and retention amounts are generally 1% of deal value or lower.

Moreover, buyers have become more comfortable with the RWI claims process. Initially, buyers were skeptical that insurers would actually pay claims made under RWI policies. However, as insurers have routinely paid valid claims over the last few years, the stereotype that it is more difficult to collect under an RWI policy than under a customary seller indemnity has been broken.

As a result of these changes, along with an increasingly competitive, seller-friendly deal climate, buyers have become more comfortable relying primarily or exclusively on RWI, which has allowed them to limit or even eliminate the traditional seller indemnity.

Limiting the Seller's Liability with an Indemnity "Strip"

Consider a $500 million transaction in which the buyer seeks a $50 million indemnity for breaches of the seller's reps. If the buyer instead obtains an RWI policy with a $50 million coverage limit and a $5 million retention, the buyer and seller will only need to allocate the risk of the first $5 million in losses between them.

Often, the parties will agree to split such losses evenly, with a deductible applying to the buyer's first $2.5 million in losses and a seller indemnity of at least twelve months applying to the buyer's next $2.5 million in losses. As a result, the seller's liability for rep breaches will be limited to a $2.5 million "strip," equal to just 0.5% of deal value.

Under many RWI policies, the retention will "drop down" to a reduced amount – generally 50% of the initial retention – on the first anniversary of the closing. When combined with a seller indemnity like the one described above, the retention drop-down limits the buyer's liability for rep breaches covered under the policy to the $2.5 million deductible, because when the seller indemnity expires, the RWI retention drops down to prevent a coverage gap.

Eliminating the Seller's Liability with a "No-Survival" Deal

Alternatively, the parties might agree to completely eliminate the seller's liability for certain rep breaches. In a "no-survival" deal, some or all of the seller's reps do not survive the closing. Accordingly, the seller will not indemnify the buyer for breaches of such reps following the closing, and the buyer will look solely to the RWI policy to recover losses from such rep breaches.

Many insurers are now willing to offer the same coverage limit, initial retention, drop-down retention, and scope of coverage in a deal <u>without</u> a seller indemnity as in a deal <u>with</u> a seller indemnity. Most insurers will impose a modest premium increase to reflect the perceived moral hazard of a no-seller indemnity transaction structure.

Using the above example, if the parties eliminate the seller indemnity, the buyer's incremental exposure will be limited to the amount that would have been covered by the seller's indemnity strip (*i.e.*, $2.5 million), with the buyer's aggregate exposure equaling $5 million, or 1% of deal value. If the RWI policy includes a typical drop-down retention, the buyer will only face this incremental exposure up until the retention drop-down date.

The General Benefits of RWI

Using RWI to limit or eliminate the seller's liability for rep breaches obviously benefits the seller. But it benefits the buyer, too.

RWI can help distinguish the buyer's bid in an auction process; in addition to making the bid more attractive economically, it can meaningfully shorten negotiations over the acquisition agreement, which can be an important factor in a competitive process.

Also, using RWI to limit the seller's liability may make the seller more willing to expand the substantive coverage of its reps and to reduce the use of knowledge qualifiers, thereby improving the buyer's basis for recovery under the policy.

The Unique Benefits of No-Survival Deals

While limiting the seller indemnity can meaningfully shorten the negotiation timeline, eliminating it entirely can dramatically simplify negotiations. For example, even in a $100 million transaction, the respective deal teams can spend a surprising amount of time negotiating a $500,000 indemnity strip.

Eliminating the seller indemnity also can enhance the buyer's coverage under the RWI policy. Most policies will include two types of "coverage enhancement." First, they will include a "full materiality scrape" – *i.e.*, they will "read out" materiality qualifiers in the reps for purposes of determining whether a rep has been breached and the amount of losses resulting from such a breach. Second, they will not impose a "damages exclusion" on the buyer's recovery – *i.e.*, they will cover a range of damages, including consequential damages and those based on multiples of earnings and lost profits.

In a no-survival deal, most RWI policies will include these coverage enhancements as a matter of course (that said, before including a materiality scrape, the insurer will want to confirm that the seller has populated the disclosure schedule without regard to the materiality qualifiers in the reps).

By contrast, in a deal with an indemnity strip, most policies will only include these coverage enhancements if the acquisition agreement includes a full materiality scrape and does not include a damages exclusion (and, as mentioned above, the insurer will scrutinize the seller's population of the disclosure schedule before including a materiality scrape). In essence, while the insurer is generally willing to offer coverage enhancements, if the seller is providing an indemnity, the insurer is generally only willing to offer such coverage enhancements to the extent the seller also does so.

Accordingly, seeking a seller indemnity can jeopardize the buyer's efforts to obtain coverage enhancements under the RWI policy, since the seller may resist a materiality scrape or insist on exclusions for certain categories of damages. By contrast, if the seller indemnity is eliminated, most insurers will provide these coverage enhancements as a matter of course.

A no-survival deal also may help the buyer preserve important relationships with the seller after the closing. At times, the buyer will be relying on a transition services agreement with the seller. In addition, members of the seller group often continue serving as members of the acquired business's management team. Under these circumstances, a seller indemnity could put the buyer in the unenviable position of suing its new service provider or management team after the closing.

Finally, from a post-closing claims administration standpoint, a no-survival deal may prove less burdensome for the buyer than a deal with an indemnity strip. When a claim arises in a no-survival deal, the buyer can work with a stable, creditworthy insurer to process the claim, rather than also having to concurrently seek a small recovery from the seller, as it would in a deal with an indemnity strip. Also, a no-survival deal allows the parties to avoid establishing an escrow fund.

The Limits of RWI

Despite its benefits, RWI is not a panacea. As its name suggests, RWI only covers rep breaches; it does not cover covenant breaches, purchase price adjustments, or other payment obligations that might arise under an acquisition agreement.

In addition, the buyer customarily purchases RWI coverage in an amount equal to approximately 10% of deal value. This leaves the buyer exposed to extraordinary losses from fundamental rep breaches in excess of the coverage limit. In a transaction with a seller indemnity, the seller might agree to indemnify the buyer for losses arising from fundamental rep breaches in excess of the RWI coverage limit. In a no-survival deal, however, it is relatively uncommon for the seller to provide a standalone indemnity for fundamental rep breaches.

RWI also can pose a trap for the unwary in terms of coverage for pre-closing taxes. RWI will cover the tax reps in the acquisition agreement, and some policies will also include a standalone pre-closing tax indemnity to the extent the seller provides one. However, as described further below, pre-closing tax coverage under the RWI policy will be limited to coverage for taxes that the buyer does not know about when the policy is bound.

So, for instance, accrued taxes for pre-closing periods that are not yet payable would <u>not</u> be covered under the policy, even though such taxes typically would be covered under the seller's standalone pre-closing tax indemnity. Thus, even if the buyer agrees to a no-survival deal, it should nevertheless consider insisting that the seller provide a standalone pre-closing tax indemnity covering taxes for which the buyer will not have coverage under the RWI policy.

Finally, most policies will include a range of coverage exclusions or limitations. First, as mentioned above, the buyer will not be able to recover for liabilities it knew about when the policy was bound, regardless of whether such liabilities are included in the disclosure schedule. Thus, the buyer's due diligence will pose a Catch-22: the buyer will want to conduct a comprehensive diligence process so that it is fully aware of all of the target company's risks, but doing so will deprive the buyer of coverage under the policy for any liabilities that it uncovers.

Second, some policies may include a blanket carve-out from coverage for certain categories of losses, including those arising from the following liabilities (whether known or unknown to the buyer): asbestos and polychlorinated biphenyls; transfer taxes, taxes accrued on the balance sheet, taxes disclosed on the disclosure schedule, and net-operating losses and other types of deferred tax assets; underfunded benefit plan liabilities; and liabilities related to employee misclassification and compliance with wage-and-hour laws.

Increasingly, some insurers are willing to at least provide "excess" coverage for some or all of the above liabilities. The buyer will look to a primary environmental, tax, benefits, wage-and-hour, or other insurance policy to recover its initial losses. Then, the RWI insurer will cover losses in excess of a specified dollar threshold – *i.e.*, the RWI policy will "sit in excess" to the primary policy.

Plugging RWI Coverage Gaps

Almost every buyer will experience some heartburn over a liability that it uncovers during diligence, or over a potential liability that it knows will be subject to an RWI carve-out or excess coverage limitation. If the buyer decides that it cannot bear the risk of such a loss, and it still wants to do the deal, then it will need to work with the seller to find a way to share the risk.

One way is through an upfront deduction to the purchase price. While this will provide the buyer with guaranteed coverage for at least some amount of the risk, a purchase price deduction is an imprecise remedy, as it might exceed or fall short of the ultimate liability.

An alternative is for the seller to provide a "special" indemnity, often backed by an escrow fund, for the identified liability. For example, the buyer may be worried about asbestos liabilities, which will be subject to a carve-out or excess coverage limitation under the RWI policy. Accordingly, the seller would indemnify the buyer for any losses arising from such liabilities, irrespective of the deductible or cap applicable to general rep breaches. While a special indemnity invites the risk of future disputes with the seller, it allows for more precision than an upfront purchase price deduction.

Finally, the buyer might simply look to utilize a primary insurance policy, with excess coverage being provided under the RWI policy. If the target company already has adequate primary insurance policies in place, then those policies often can be rolled over post-closing. If such policies are inadequate, then the RWI insurer often will be willing to underwrite an environmental, tax, benefits, wage-and-hour, or other primary insurance policy to go along with the RWI policy.

Gibson, Dunn & Crutcher's lawyers are available to assist with any questions you may have regarding these issues. For further information, please contact the Gibson Dunn lawyer with whom you usually work or the authors of this alert:

Jeffrey A. Chapman - Dallas (+1 214-698-3120, jchapman@gibsondunn.com)
Jonathan Whalen - Dallas (+1 214-698-3196, jwhalen@gibsondunn.com)
Benjamin A. Bodurian - Washington, D.C. (+1 202-887-3688, bbodurian@gibsondunn.com)

Please also feel free to contact any of the following practice group leaders:

Mergers and Acquisitions Group:
Barbara L. Becker - New York (+1 212-351-4062, bbecker@gibsondunn.com)
Jeffrey A. Chapman - Dallas (+1 214-698-3120, jchapman@gibsondunn.com)
Stephen I. Glover - Washington, D.C. (+1 202-955-8593, siglover@gibsondunn.com)

GIBSON DUNN

Private Equity Group:
Sean P. Griffiths - New York (+1 212-351-3872, sgriffiths@gibsondunn.com)
Steven R. Shoemate - New York (+1 212-351-3879, sshoemate@gibsondunn.com)
Ari Lanin - Los Angeles (+1 310-552-8581, alanin@gibsondunn.com)
Charlie Geffen - London (+44 (0)20 7071 4225, cgeffen@gibsondunn.com)
Paul Harter - Dubai (+971 (0)4 318 4621, pharter@gibsondunn.com)