

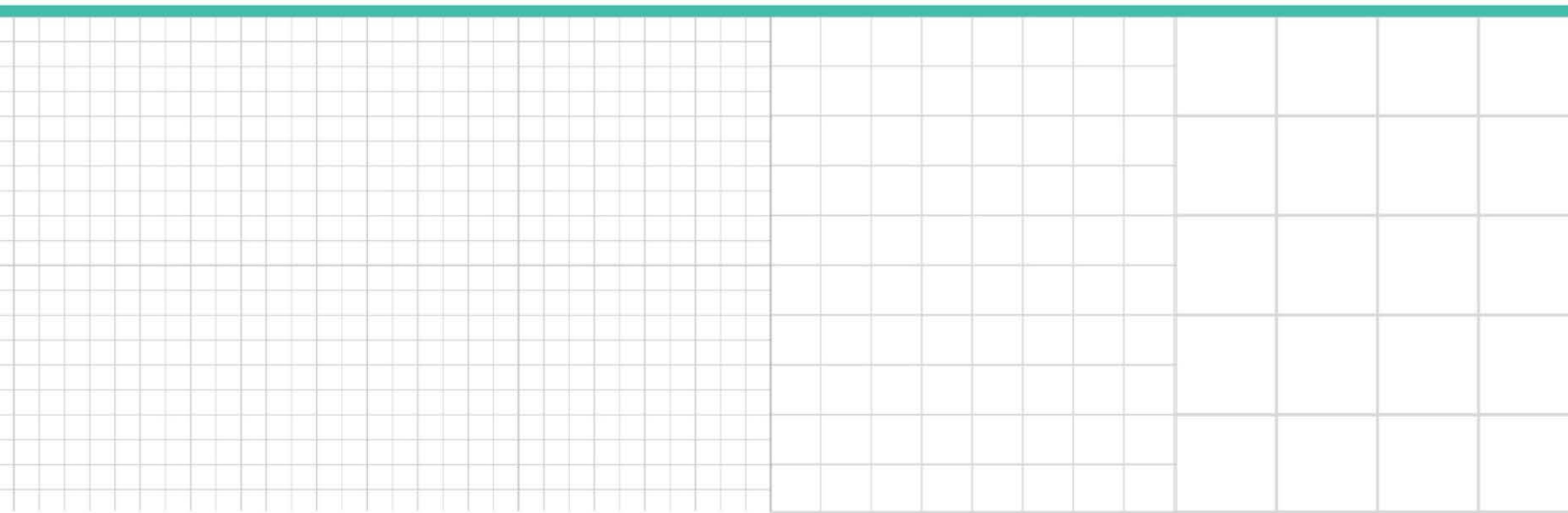


Professional Perspective

# Representations & Warranty Insurance

*Daniel Avery, Goulston & Storrs*

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# Representations & Warranty Insurance

Contributed by [Daniel Avery](#), Goulston & Storrs

## Market Trends: What You Need to Know

RWI is an increasingly important feature of private company M&A transactions. Every other year since 2005 the ABA has released its Private Target Mergers and Acquisitions Deal Point Studies (the "ABA studies"). The most recent two of these studies (2017 and 2019) have looked at representation and warranty insurance ("RWI") in private company merger and acquisition ("M&A") transactions.

As shown in these two most recent ABA studies:

### **RWI References**

The percentage of transactions expressly referencing RWI increased from 29% in the 2017 study to 52% in the 2019 study.

### **Bound by Closing**

58% and 59% of the deals with RWI reported in the two studies, respectively, did not expressly require the policy to be bound at Closing.

### **Who Acquires the Policy?**

The buyer acquired the RWI policy in 93% and 95%, respectively, of the RWI deals reported in the two studies.

### **Obligation to Pursue RWI**

An indemnitee's obligation to first pursue RWI coverage was included in 42% of RWI transactions, in both of the studies.

### **RWI Payment**

In most cases, the buyer bore full, or shared with the seller, responsibility for RWI premium payments. The seller bore full responsibility for payment in 10% or so of reported transactions.

### **RWI As Sole Source of Recovery**

Express negative statements to the effect that RWI is not the sole source of recovery increased from 2017 to 2019, seen in 20% and 54%, respectively, of reported transactions.

### **RWI and Indemnity Caps**

Indemnity caps were lower in reported deals where RWI was referenced in the deal documents, as compared with transactions without any such reference.

### **RWI and Indemnity Baskets**

When reviewed in relationship to indemnity baskets, any linkage of indemnity baskets to RWI references seem tenuous if not absent.

## Introduction

In M&A transactions, the definitive purchase agreement (whether asset purchase agreement, stock purchase agreement, or merger agreement) typically contains representations and warranties made by the seller with respect to the target company. Representations and warranties not only provide information to the buyer, but also operate to allocate risk as between the buyer and seller with respect to the matters covered by the representations and warranties.

Historically, sellers were responsible for damages suffered by buyers and caused by breaches of the seller's representations and warranties, through indemnification provisions. Pursuant to indemnification provisions, any given party would agree to defend, hold harmless, and indemnify the other party or parties from specified claims or damages. Those defense and indemnification obligations are often limited by time, dollar levels, and/or types of claims and damages.

In the past 10 plus years, buyers and sellers have been able to outsource the exposure to buyers from breaches of seller representations and warranties to third party insurers issuing RWI policies. This article looks at the ways that RWI is addressed in private company M&A agreements, as reflected in the relevant ABA studies.

## The Growth of RWI

One of the biggest changes in private company M&A during the past decade has been the enormous growth of RWI. With RWI, buyers and sellers are able to allocate some of the post-closing M&A indemnity risk to third party insurers. RWI has gone from being a differentiator that aggressive buyers offered to a much more common feature of private M&A deals. As indemnity risk has been shifted through RWI from sellers to third party insurers, avenues for a buyer's indemnity recourse against sellers have narrowed, including through the lowering of indemnity caps and even the elimination of post-closing seller indemnity for representations and warranties (subject to narrow exceptions, such as in the event of fraud).

The most recent two ABA studies have looked at certain RWI-related provisions in reported private company M&A agreements. It is worth noting, however, that relying solely on explicit references to RWI in M&A transaction documents as evidence of RWI's usage is potentially imperfect. In the author's experience, sellers may insist that they have minimal involvement with or "connection" to the RWI insurer or the RWI process, and that the buyer should deal with indemnity risk wholly on its own, whether through RWI, self-insurance, and/or negotiations with the seller in the M&A documents. In that context, there may be no need or desire for any explicit reference to RWI in the executed agreements. This approach is driven at least partly by the concern that if faced with claims, insurers may seek third party beneficiary, subrogation, privity or other means of recourse against the seller (notwithstanding language in the documents to the contrary), and the view that reducing any documentary connections with, or even references to, RWI could assist in a seller defense against such insurer claims. In addition, where the seller, and not the buyer, is acquiring the RWI policy, one would expect there to be no need to reference the policy in the M&A documents (though those situations would likely not see an impact on seller indemnity caps or baskets). As a result, it is possible if not likely that some meaningful number of M&A deals with RWI have no references in the deal documents to the insurance policy itself or to RWI generally.

## Trends in RWI

The ABA studies examine purchase agreements of publicly available transactions involving private companies. These transactions range in size but are generally considered as within the "middle market" for M&A transactions; the median transaction value within the 2019 study was \$145 million.

The ABA Study in 2017 was the first to review the use of RWI in private M&A transactions. Accordingly, ABA study data is limited to two of the eight ABA studies (2017 and 2019). Given the growth of RWI, it is fully expected that future ABA studies will continue to look at RWI.

### **Basic RWI Data**

#### *RWI References*

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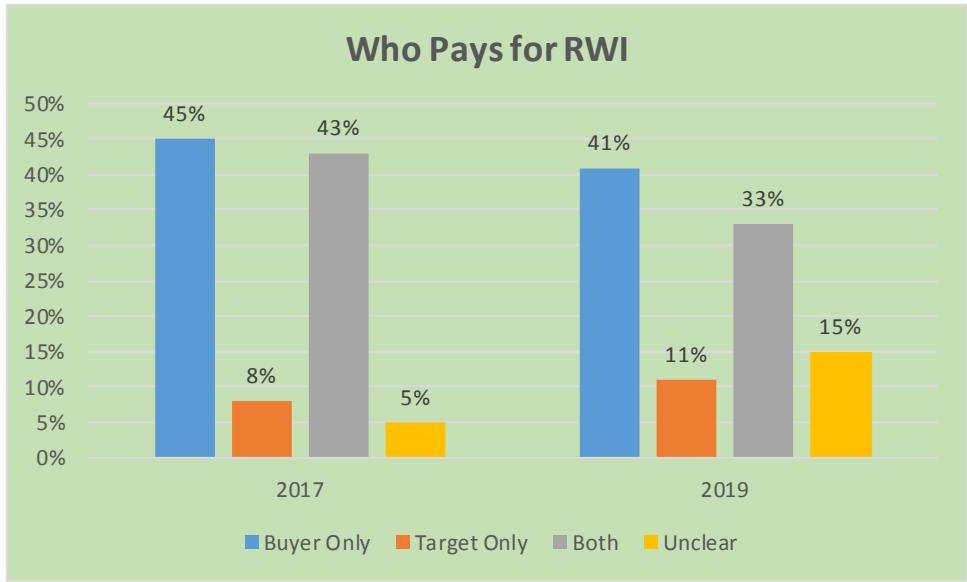
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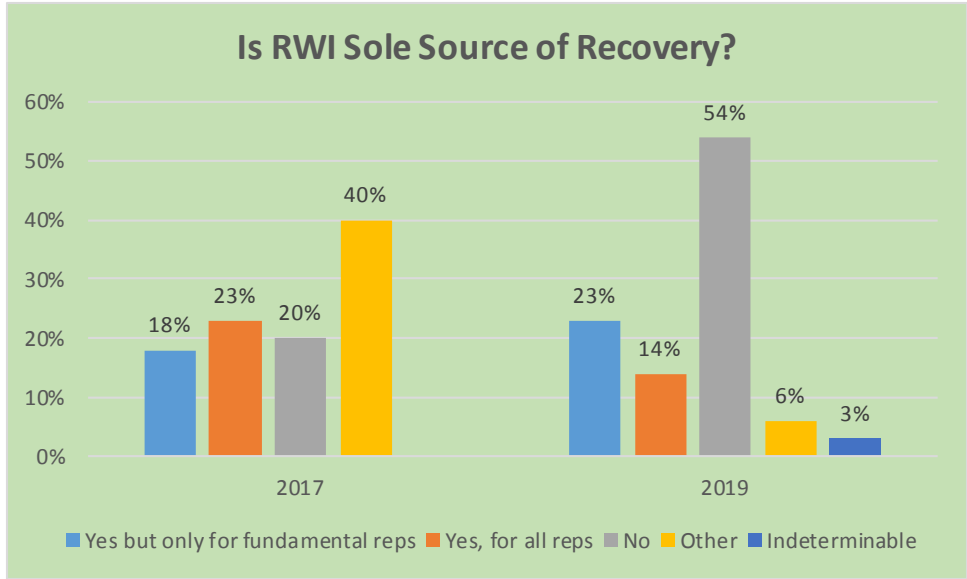
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**RWI As Sole Source of Recovery**

Express negative statements to the effect that RWI is not the sole source of recovery increased from 2017 to 2019, seen in 20% and 54%, respectively, of reported transactions.



**RWI and Indemnity Caps**

As shown in the charts below, the 2017 and 2019 ABA studies each showed that indemnity caps were lower in reported deals where RWI was referenced in the deal documents, as compared with transactions without any such reference.

<b>2017 Indemnity Cap</b>	<b>Overall</b>	<b>No RWI Reference</b>	<b>RWI Reference</b>
Indemnity Cap Mean	12.20%	14.70%	5.77%
Indemnity Cap Median	8.40%	10.00%	1.00%
<b>2019 Indemnity Cap</b>	<b>Overall</b>	<b>No RWI Reference</b>	<b>RWI Reference</b>

Indemnity Cap Mean	8.99%	11.99%	5.82%
Indemnity Cap Median	5.00%	10.00%	.54%

### **RWI and Indemnity Baskets**

On the other hand, when reviewed in relationship to indemnity baskets, any linkage of indemnity baskets to RWI references seem tenuous if not absent. The following charts show the relevant data:

<b>2017 Indemnity Baskets</b>	<b>Overall</b>	<b>No RWI Reference</b>	<b>RWI Reference</b>
All Baskets: Mean	.79	.77	.84
All Baskets: Median	.59	.66	.50
All Deductibles: Mean	.73	.64	.94
All Deductibles: Median	.58	.63	.50
All Tipping Baskets: Mean	.91	1.02	.36
All Tipping Baskets: Median	.53	.63	.32
<b>2019 Indemnity Baskets</b>	<b>Overall</b>	<b>No RWI Reference</b>	<b>RWI Reference</b>
All Baskets: Mean	.55	.59	.51
All Baskets: Median	.50	.50	.50
All Deductibles: Mean	.58	.65	.51
All Deductibles: Median	.50	.53	.50
All Tipping Baskets: Mean	.45	.45	.47
All Tipping Baskets: Median	.42	.36	.50

## **Conclusion**

RWI is an increasingly important feature of private company M&A transactions. Since only the two most recent ABA studies looked at RWI, data is still too light to identify many trends beyond the fact that RWI is now seen in more than half of reported private company transactions. Even in the absence of long term data, it seems clear that RWI will continue to be an option for buyers and sellers looking to allocate representation and warranty indemnity risk beyond the primary transaction parties.