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Reps & Warranties Insurance: Five Myths Dispelled

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For several years, buyers and sellers in M&A deals have been turning to representations and warranties (R&W) insurance to allocate risk—and they continue to do so during these unprecedented times. Yet, despite the increasing prevalence of R&W insurance, myths and misconceptions remain. When they are debunked, buyers should have a clearer understanding of the benefits that R&W insurance can bring to a deal. Here are five myths about R&W insurance dispelled.

Myth No. 1: R&W insurance policies will not cover the seller's fraud.

Because R&W policies are designed to cover breaches of a seller's and an acquired company's R&Ws, the policies will likewise cover fraudulently made representations. What is critical for the buyer to do to trigger coverage is establish that a breach occurred—regardless of how or why it occurred, i.e., inadvertently or intentionally.

The risk of seller fraud is one that the buyer cannot easily diligence: the seller is the source of information to evaluate the target during the diligence process. Therefore, a key benefit of R&W insurance is that it covers this buyer "blind spot."

In fact, R&W policies expressly contemplate coverage for seller fraud. They have subrogation provisions that allow the insurer (if it paid a claim) to "step into the buyer's shoes" and enforce the buyer's rights against other responsible parties. While R&W insurers agree to waive their subrogation rights against the seller, that waiver does not extend to fraud. Thus, while insurers assume the risk of breaches caused by seller fraud, they preserve recourse against the seller in those instances.

Because R&W insurers have subrogation rights against sellers in the case of fraud, buyers must give careful attention to the scope of any release given to a seller when resolving indemnification claims. If a buyer gives a seller a broad and complete release and later seeks coverage for a breach that could be a product of fraud, the R&W insurer may resist providing coverage on the grounds that the buyer prejudiced its subrogation rights.

Myth No. 2: R&W insurance coverage is not available for breaches first occurring between signing and closing.

For a while, this myth was true: R&W policies did not cover breaches that first occurred during the time between signing and closing if the buyer obtained actual knowledge before closing, i.e., "interim breaches." Consequently, buyers in an R&W deal with a staggered signing and closing faced a catch-22: Should the buyer remain ignorant of interim breaches (to preserve coverage) or be informed about breaches involving the company it is set to acquire (at the risk of losing coverage)?

Some R&W insurers have resolved the catch-22 as they attempt to stand out from their competition. Those R&W insurers will cover interim breaches or agree to erode the policy retention for those losses (for an added premium, of course). Interim breach coverage applies in varying ways. For longer interim periods, the interim breach coverage can start

45 days after signing and continue to closing. Some carriers may cover interim breaches from inception but only for a certain number of days. Another option includes covering a subset of representations during the entire interim period.

Myth No. 3: An R&W insurance policy has a "laundry list" of exclusions that defeat its value.

For buyers that view R&W insurance through the lens of standard "business" insurance policies or European-style R&W policies, this myth may ring true. But U.S. R&W policies have limited standard exclusions and usually end up with just a few deal-specific exclusions. The standard exclusions are not typically controversial: breaches the deal team members have actual knowledge of; purchase price adjustments; unfunded or underfunded pension liabilities; breaches of covenants; asbestos and polychlorinated biphenyls; and a few others.

The main concern for buyers is the deal-specific exclusions. Insurers are not shy about adding such exclusions, but they rarely amount to a "laundry list." R&W insurers—to varying degrees—tend to be upfront in their initial proposals about matters they will or may exclude after further underwriting. This informs buyers about the scope of the possible exclusions from the outset. For instance, these days buyers are sure to see COVID-19 matters and Paycheck Protection Program (PPP) loans identified as heightened risks or exclusions. Ultimately, the exclusions are either (i) a product of issues discovered during the buyer's diligence (which the buyer might address with a specific indemnity) or (ii) as a result of failing to diligence a material aspect of the target. However, the ability to minimize the number and scope of deal-specific exclusions—including COVID-19 and PPP loan exclusions—will depend on the diligence conducted as well as selection of a commercial R&W insurer, which leads to the next myth.

Myth No. 4: It's okay to select an R&W insurer based on premium alone because the insurers are pretty much the same.

Buyers should not be "penny-wise and pound foolish" when selecting an R&W insurer: They are not created equal. Not only must buyers consider the premium, but they must also evaluate R&W insurers on factors beyond their written proposal.

Buyers need to know how R&W insurers behave during the underwriting process. Is the insurer slow to respond, dragging the R&W insurance behind the deal? Does the insurer "sweat the small stuff" when reviewing the buyer's diligence, leading to irrelevant or immaterial follow-up questions? Is the insurer commercial when negotiating the policy and open to ways to remove or narrow deal-specific exclusions? If the target is in a high-risk industry, the buyer should consider whether the R&W insurer has a particular expertise in (and comfort with) that industry.

But perhaps the most important question is: Does the R&W insurer pay claims? We conducted a survey of R&W market participants to answer that question: "Getting Paid: A Look at R&W Insurance." It turns out R&W insurers do pay claims (with caveats). However, buyers should consult with their coverage counsel and brokers to understand individual insurers' reputations and whether they behave commercially during the claim process.

These questions are increasingly important as the number of new (and untested) R&W insurers has spiked in recent years. To gain market share, these "new kids on the block" may be extra-competitive on premiums (and other terms). But they may fall short when underwriting or in their willingness to stand behind their policies, making the vetting of insurers at the proposal stage critical to the value of the R&W insurance purchased.

Myth No. 5: The seller must agree to have some "skin in the game" to access the R&W insurance market.

The prime reason sellers favor R&W insurance deals is that the insurer assumes the bulk (or all) of the seller's indemnification obligation as compared to a traditional deal structure. In an R&W deal, the seller's indemnification obligation for breaches of general reps is often limited to a relatively small indemnity escrow, usually 50% of the policy retention (and the sellers may also have indemnification obligations for deal-specific exclusions and fundamental rep breaches).

Theoretically, this is the preferred deal structure for R&W insurers: They like to see sellers stand behind their representations financially. Even so, R&W insurers are willing to cover representations in a seller "walk away"

transaction. In fact, that willingness makes R&W insurance increasingly popular in public or public-style deals where the sellers are not providing indemnification.

What has evolved regarding R&W insurers' coverage for "no seller indemnity" deals is the pricing compared to a seller-indemnity deal. When R&W insurance started gaining momentum several years ago, the premium for an R&W policy in a "no seller indemnity" deal was much higher than for deals where the buyer and seller split responsibility for the policy retention. But carriers have not experienced a meaningful disparity in claims for no-seller-indemnity deals versus deals where the seller has skin in the game (which our survey confirms). As a result, the premium differential between the two deal structures has plummeted.

Conclusion. With these five myths debunked, buyers can better approach the R&W insurance placement and underwriting process and, as a result, maximize the value of their R&W insurance.

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