Lowenstein Sandler's Insurance Recovery Podcast: Don’t Take No For An Answer

Episode 18 -
Reps & Warranties Insurance: Sealing The Deal

By [Lynda A. Bennett](), [Eric Jesse](), and Michael Wakefield
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Lynda Bennett: I'm your host, Lynda Bennett, Chair of Lowenstein Sandler's Insurance Recovery Group. Today, we're going to talk about an insurance product that has truly transformed the M&A world over the past several years, reps and warranties insurance. While reps and warranty insurance has been around for decades, it began to gain popularity over the last six to seven years in the United States, with a hockey stick trajectory, as private equity firms and strategic buyers increasingly purchased reps and warranty insurance and as many new insurers jump into this market.

We used to tell our buyer side clients that reps and warranty insurance was a way to stand out in the auction process. But today, the reality is that reps and warranties insurance is required in a bid, just to stay competitive. Traditionally, in M&A deals sellers often had to stand behind the reps and warranties that they made about the company. They did so by agreeing to indemnify the buyer and to put a hefty escrow up for losses related to any breeches or inaccuracies in the reps and warranties that they made. But, reps and warranties insurance changes that dynamic. Reps and warranty insurance is designed to largely, and sometimes entirely, take on the seller's indemnification obligations.

Now, in reps and warrantied deals, sellers only have to put up a limited escrow, usually about half a percent of the target enterprise value, for a limited period of time, often a year. In many rep and warranty deals, the seller doesn't have to provide any escrow or indemnification.

Today, we're going to talk about the current state of play in the rep and warranty insurance market, how it's changed in a COVID-19 world and where it seems to be going. I'm thrilled to be joined today by Michael Wakefield, the transaction liability practice group leader from CAC Specialty, and my partner Eric Jesse, of Lowenstein Sandler's insurance recovery group. Michael is an insurance broker who has extensive experience placing insurance solutions, including reps and warranties, in M&A deals. Eric works on behalf of buyers in M&A deals, to negotiate policy forms, narrow exclusions and guide buyers through the R&W underwriting process. Together, they have extensive experience on the front lines of R&W insurance in a variety of deals, industries and interfacing with reps and warranties insurers.

Lynda Bennett: So with that, let's jump in. Welcome, Michael. Welcome, Eric. Glad to have you today.

Eric Jesse: Thank you. Happy to be here.

Michael Wakefield: Glad to be here, thanks.

Lynda Bennett: All right, let's start out, and I'll throw this open as a jump ball, whoever wants to grab it first can go. When you're advising buyers on who to select as your reps and warranties insurers, what are some of the factors that you give consideration to?

Eric Jesse: So when we're advising buyers on the insurers that they should select as part of this process, because the broker will go out and often get a number of different quotes from different carriers, we want to understand what their underwriting process is. Are they responsive? Are they timely? Are they commercial and policy negotiations? Particularly today, and this is probably something Michael can talk about as well, R&W insurers are very, very busy. We want to make sure that they can close a deal on time and keep pace with the deal.

One other important factor that I look to is just that I look for carriers that aren't going to sweat the small stuff on diligence. That they really can put things in perspective and really focus on the key items in a deal that matter.

And then, of course, a key component is do the insurers pay claims. Last year, we at Lowenstein conducted a survey of approximately 150 market participants to really answer that question of do carriers pay claims, and overall, the results back were that they do pay claims but it does take work. But, we do want to know what the carrier's reputation is in the market, for paying claims.

Lynda Bennett: So Michael, let me throw this one to you. Has the market stabilized, in terms of the number of insurance players that are willing to write this type of coverage? Or, are you still seeing a lot of new entrants to this particular space?

Michael Wakefield: It really has not stabilized. We see new entrants, we have two coming on I think in the next six months. We had one come on and then exit in the last six months. And, over the last year or two, have had a number of new players.

That comes back to your original question and I would add a few things. I agree with all of Eric's points on what we consider when we look for underwriters for a particular deal. But, I would add one thing to think about is are you dealing with a managing general agent or underwriter, who underwrites on behalf of insurance carriers? Or, are you dealing with an insurer itself, who has an underwriting team in-house? There are arguments on both sides, I'm not necessarily saying one's better than the other, but there are pros and cons in each direction.

As far as the process goes, a lot of the MGAs and MGUs in particular will have a call without underwriting counsel on the call and some of the insurers will do that. That seems like a small thing. You have a two hour call, that's the core of the underwriting process, and whether outside counsel for the underwriter is on or not, it seems to be a small thing. But a lot of times, deals go more smoothly when they're not. I don't know why that is, but it's something we think about.

One more factor I'd throw out is think about if you're building a large tower, the credibility that the lead underwriter has with excess markets, to have excess markets follow form to underwriting and coverage. Some insurers have more credibility than others, in that sense.

But to circle back, Lynda, to your question, the market it feels volatile. We as a broker, that's a bit part of what we stay up at night thinking about, is are we going to place risk of our clients with an underwriter that's not going to be here when the claim comes in. We're very comfortable and confident that the insurers, and most of these are MGAs, MGUs that are the ins and outs of the space, we're very comfortable and confident that the insurers are going to be there in the long run because they're large insurance companies. But, you want somebody who has the reputational risk if there's a claim to know that, if they don't deal fairly, their business will not continue as much as it has in the past.

Those factors all come into play. We think through a lot of factors, as you can tell.

Lynda Bennett: Yeah. I agree and it's something that we constantly counsel our clients on. Getting the insurance policy is one thing, but getting it with a carrier that has the intention, as Eric said a couple of minutes ago, with the plan to pay the claim, pretty important. So we do reinforce that message, that who you're insuring with matters as much as the words on the page.

But, let's transition now into what are some of the changes that have taken place? We're about a year into the pandemic. Michael, you've noted that the market's a little bit volatile. What are some of the key changes that you've seen over the last year? And if you've got your crystal ball polished up, what's on the horizon for the next six months in this space?

Michael Wakefield: Well, I can't promise to have a crystal ball. But, I will say pricing is the headline and there's a reason for that. Pricing is significantly higher today, for any given deal, than it was a year ago, for sure. A year ago, we were in the middle of a lull in M&A due to the COVID pandemic. Now, we've had this extended run of the busiest time the market has ever seen and it's lasted from about last fall until literally today. Every day I feel like I hear an underwriter say, "We've had more submissions today than we've ever had before, again."

I believe that the drive in higher pricing is largely due to that really high demand. There's an argument that higher pricing is justified by claims experiences of the underwriter should have been doing this a long time. That's a little bit TBD. When you look around the market, there are a lot of underwriters who don't have those heavy claims books. The question becomes whether different underwriters are going to have different claims experiences, or whether a mature book of business necessarily has claims that justifies higher rates.

I think the headline, again, is the pricing. The question we have there is whether that's merely a function of demand or a function of claims experiences. Along with the demand comes underwriters have a little bit more leverage to restrict terms. I think we have a little bit of an underwriters' make and that's my point. I'll pause there.

Lynda Bennett: Yeah. Let me throw it over to Eric, because you have eyes on these policies on a regular basis. What are some of the changes that you've seen, specifically related to COVID? And, either restriction in terms or new exclusions perhaps. What are you seeing there?

Eric Jesse: Yeah. One thing we saw in March, April, May of last year is that COVID-19 exclusions were common place on these policies. They could often be very broad, just applying to anything that relates to the company's operations, its supply chain, its employment relationships. What we've seen since then is that those exclusions are becoming much more relaxed. There are certain carriers in the market that still insist on having broad exclusions, but we find that there are a number of carriers that are willing to negotiate those exclusions or keep an open mind on them.

Today, we're seeing either policies that have no COVID exclusions, hopefully. Or, the broadest exclusion we're seeing is a relatively narrow one, which just relates to the failure to prevent the transmission of COVID to employees or people that are onsite.

Another impact of COVID that we've seen that seems to be here to stay is that there are exclusions for PPP loans and other CARES Act relief or grants that companies have received. Those exclusions seem to be staying and are becoming part of what's standard on these policies.

Lynda Bennett: Michael, you mentioned that there's competition. You mentioned that the underwriters are super overworked. What are some of the hot button issues that are coming up through the underwriting process, other than COVID-19? If I'm a policy holder looking to potentially get into this market, what are some of the things I better make sure I have buttoned up before I get on the phone call with the underwriter for the first time for my deal?

Michael Wakefield: That's a great question. I would go back to mention one thing Eric said earlier, which is making sure the underwriter has capacity to get a deal done on time. My job as a broker, in a lot of ways ... Obviously, I would say the job is way more expansive than this. But, one of the main things we have to do as a broker is to make sure that rep and warranty insurance doesn't impact deal timing. Our job these days, in a busy market, is largely to make sure the underwriter knows that we're going to do this on this timeline and, "I know you're busy, but this deal is important, it needs to be your first priority." That as a small aside.

I would say a big trend that I'm watching closely, and I think everybody in the industry is, are the edits for policy purposes only that underwriters are proposing to purchase agreements. If you know rep and warranty insurance, you know the coverage follows the reps and warranties in the purchase agreement. For a lot of years, if I went back probably two years to the quotes we got, you wouldn't see any comments in a quote on the purchase agreement. Now, when we find a handful of leaders, leading underwriters, bidding for a deal, we'll go back to them with the draft purchase agreement and say, "Please update, refresh your terms, in accordance with this purchase agreement." We'll sometimes get a page or more of for policy purposes edits.

For example, they'll say, "In Rep A, we're going to knowledge qualify it," even if you don't knowledge qualify it in the purchase agreement. That I find to be a little bit troubling. The underwriter's view is "purchase agreements have gotten so buyer friendly that we have to do this to protect ourselves." I get concerned that what they're actually saying is, "We've had claims experiences and we want to not have those claims experiences anymore."

Lynda Bennett: You're a good cynic to join us on Don't Take No for an Answer, here. You're speaking my language.

Michael Wakefield: Well, I come from your background, too. I was an insurance recovery attorney before being a broker. I can talk about that for a long time, but I'd like to hear Eric's thoughts on it as well.

Eric Jesse: Yeah. On the rewrites, I call those the hidden exclusions. One thing that buyers need to keep in mind is, a lot of times, the buyer will try and negotiate from the seller an indemnity for R&W excluded matters. They'll just look to the exclusions section of the policy to identify what those are. But also, they need to keep in mind that they're including any significant rewrites to these reps to include there.

Another issue we see carriers focusing on is valuation. A lot of times, even after the quote is issued but before the carrier is willing to sign up, they want to understand how the deal was valued, and whether a multiple was used, whether comparables were used. I think that's because of the claim severity that a number of carriers are experiencing because, if there's a financial statement breach claim that's going to be made, we as the policy holder and buyer advocate are going to argue that that loss should be a multiple of the damages, so that's another increasing area of focus.

Lynda Bennett: All right, so let's get our crystal ball polished up and project out. What are the next couple of years in the reps and warranty insurance market going to look like? What are some of the trends that you're going to expect to see? Michael, why don't you go ahead and give it to us first?

Michael Wakefield: One thing I'm going to watch is whether the markets claims experiences reflect the current insurers claims experiences, that have those mature books of business, like we mentioned a minute ago. I think there's a big question in a new insurance market of whether this kind of insurance necessarily has a certain loss ratio, or whether there actually are better ways to underwrite this kind of business. Whether that's picking clients, picking industries, picking brokers. Ha ha, I'm joking. But, you know what I mean.

Lynda Bennett: Shameless plug received. Got it. That's great.

Michael Wakefield: Right, right. Thanks.

But, I'm very curious about this because we're in this demand moment where we have new insurance. But then, we have established players who are saying, to be sustainable, we have to do things a little bit differently. I wonder if the new players have some secret sauce that is actually going to result in a different longterm result. I think that as those new players have maturing books of business, we're going to see some really interesting things.

Lynda Bennett: Yeah. But as we know, new players taking that leap of faith, because as Eric mentioned before, the number one question we get from clients at the front end of this process is, "But are they going to pay the claim?" It's a bit of a tough sell for those new entrants to comfortably say, "Yeah, go ahead and go with them."

Eric, what do you see? We've got just a couple minutes left, I've got one more question up my sleeve that I've got to pull out.

Eric Jesse: One thing that concerns me going into the future is that, as reps and warranty insurance becomes even more popular and more standardized in deals, that the insurers are just going to feel that they can take a much more difficult position on claims. I think, to date, because the rep and warranty insurance community is relatively small and reputations matter, carriers I think by and large are being commercial because, if they are difficult on claims, word is going to get around. But, as the demand for the policy increases, my concern is that R&W insurers are going to start to behave like other insurers that we often have disputes with.

Lynda Bennett: All right, great. I've got just a couple of minutes left here and I did want to circle back. I was going to ask this question earlier, Michael, when you were talking about how busy those underwriters are. I'm curious to know, how much of that is being driven by the SPAC craziness that we're hearing about out there in the marketplace? Has rep and warranty started to intersect with those SPAC deals? If not, is that something you see on the horizon?

Michael Wakefield: It has not yet, really. There's a lot of talk about it. I know that the number of placements is still very low. It's not the SPAC craziness that's driving the current demand. But, rep and warranty insurance can be a great tool in the SPAC transaction and there are some nuances to that that we could fill a whole nother podcast with. But in short, it could be coming but it takes some specialized knowledge of the SPAC space and how underwriters are going to react to some particular nuances within those deals.

Lynda Bennett: Eric, any parting shots on SPACs?

Eric Jesse: Yeah. On SPACs, I think that reps and warranty insurance can play a role in SPACs, I think for much of the same reason it plays a role in M&A deals, because it allows for a limited or a no seller indemnity. There's reduced time spent negotiating the claims, and negotiating the reps and indemnity package, and avoiding the need to serve breach claims against the holdover management. It's certainly something on the horizon.

Lynda Bennett: All right. Well, I'd like to think Michael and Eric for sharing their experience in the reps and warranty insurance space. I'm convinced that this is an emerging area, it's not going anywhere. You're both going to stay plenty busy, and we'll be very happy to have you come back and give us a review of what's going on in six months or so. Thanks for joining us today on Don't Take No for an Answer and we'll see you next time.

Eric Jesse: Great.

Michael Wakefield: Thank you for having me.

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