

How Reps And Warranties Insurance Can Aid Sellers In M&A

By **Alex Leibowitz and Eric Jesse** (September 19, 2023, 2:48 PM EDT)

Activity in mergers and acquisitions remains at a multiyear low, and although sellers may not be able to control the conditions causing the current slowdown, those fortunate enough to identify an acquirer can make one important decision to maximize the likelihood their M&A transaction closes.

In exchange for a relatively small upfront cost, parties to an M&A transaction can purchase representation and warranty insurance to insure against liabilities that may be unknown or difficult to identify and make the overall deal negotiating process faster and less frustrating for all parties. RWI has never been more widely accepted or affordable than it is today.

Representations and warranties serve important purposes in M&A deals. Unfortunately, a small percentage of representations and warranties usually take a disproportionately large amount of time to negotiate, and drawn-out negotiations increase deal cost, leaving everyone feeling frustrated.

This small subset of representations and warranties often involve liabilities that are unknown or difficult to identify, including there being no undisclosed liabilities, IP infringement, matters that could give rise to litigation, financial statement misrepresentations or unpaid pre-closing taxes — whether or not known.

While buyers frequently take a not-my-problem approach to liabilities that are unknown or difficult to identify, sellers often view these same liabilities as the cost of doing business and the reason a company carries business insurance.

For a long time, there was no alternative to protracted and contentious negotiation, but over just the last few years buy-side RWI has proven itself a worthy alternative. In exchange for a premium that can range from 2.5% to 3% of the desired policy limit, plus a \$40,000 to \$45,000 underwriting fee and broker fees, parties to an M&A deal can purchase representations and warranty insurance for a transaction.

In many deals, these RWI costs are shared between buyer and seller 50/50, although in competitive auction settings buyers frequently pay the full cost of RWI.

These policies cover losses resulting from breaches of negotiated representations and warranties, as well as, in most cases, market-standard unpaid pre-closing tax liabilities of an acquired business that are



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unknown to the buyer, whether or not a breach of a representation or warranty exists.

Typically, buyers tend to purchase limits of liability that equal 10% of the purchase price — but buyers can consider different limits based on their risk tolerance or purchase excess policies covering a subset of representations and warranties. The policy retention is usually 0.5% to 0.9% of the enterprise value. After 12 months, the retention typically drops, corresponding with the release of the escrow funds to the seller.

A key benefit to the parties — both buyer and seller — in an RWI deal is that negotiations over the key representations and indemnification provisions are significantly smoother because the representations and warranty insurer is bearing much of the responsibility.

In addition to insuring against liabilities that may be unknown or difficult to identify, a factor that makes negotiating representations and warranties faster and less frustrating, RWI affords sellers additional benefits:

First, because of RWI, some sellers have leverage to insist on a no-seller-indemnity deal, where the buyer's sole recourse for a breach of representation or preclosing tax indemnity is against RWI.

Second, more often, in M&A deals where the buyer has agreed to purchase RWI, the sellers' aggregate liability for business and operational representation and warranties is usually capped at a portion of the RWI policy retention. Typically, the retention is shared 50-50 between the buyer and the seller.

Without RWI, the sellers' aggregate liability for breaches of these types of representations and warranties is usually closer to 10% of the purchase price.

Third, while typical escrow or holdback sizes range from 10% to 20% of a deal's purchase price, in deals where the buyer has purchased RWI this figure equals the seller's share of the RWI policy retention. Thus, RWI allows more consideration to be paid to sellers at closing compared to traditional deals.

Fourth, more than 50% of the deals analyzed in a recent deal study included sandbagging provisions allowing the buyer to bring an indemnification claim for a breach of a representation and warranty even if the buyer had actual knowledge the representation and warranty was untrue prior to closing.

However, because RWI policies will have an exclusion for actual knowledge of a buyer's deal team members, it is uncommon to see sandbagging provisions in RWI deals, and because seller liability is often linked to the RWI policy, the practical effect on the sellers' liability is similar to including an anti-sandbagging provision.

Not surprisingly, fewer than 5% of the deals analyzed in that same study that involved RWI included anti-sandbagging provisions — the remainder did not address this issue.

Fifth, sellers who are not operators of the business being acquired should take comfort that most RWI policies, when purchased by the buyer, will cover fraud. However, the R&W insurer does reserve the right to assert claims against the seller in the case of fraud — but not for other claims that do not rise to fraud.

For maximum protection from such a claim, sellers should ensure that an underwriter's subrogation rights are limited to instances of fraud (as defined in the purchase agreement) and then only against the

perpetrator of fraud.

Finally, to the extent that sellers have any indemnification obligations beyond the escrow, e.g., in the case of a breach of a fundamental representation, sellers can still benefit from RWI because such a claim, if covered by RWI, will offset the seller's indemnification obligation.

Risk-averse sellers, sellers that want a faster and less frustrating experience, and sellers that don't believe it is fair to require sellers to indemnify an acquirer against liabilities that are unknown or difficult to identify, should consider requiring an acquirer to purchase RWI. Representation and warranty insurance policies vary by carrier and are negotiable, so it is important to work with experienced legal counsel and insurance brokers.

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