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Using Representations and Warranties Insurance in Mid-Market M&A Deals

Takeaway: Representations and warranties insurance can help facilitate the transaction process while offering business owners a strengthened bargaining position, favorable exit terms, and improved economics.

The Traditional Negotiation Process

For most entrepreneurs, the negotiation of the [purchase and sale agreement \(PSA\)](http://www.divestopedia.com/definition/4580/purchase-and-sale-agreement-psa) (<http://www.divestopedia.com/definition/4580/purchase-and-sale-agreement-psa>), can be one of the most important - and often taxing - aspects of selling their business. The use of words such as [holdback \(or escrow\)](http://www.divestopedia.com/definition/844/holdback) (<http://www.divestopedia.com/definition/844/holdback>) and [indemnity](http://www.divestopedia.com/definition/4933/indemnity) (<http://www.divestopedia.com/definition/4933/indemnity>) can be confusing to many, and yet they remain an integral part of the process. [Becoming familiar with these terms is important](http://www.divestopedia.com/2/4691/sale-process/purchase-and-sale-agreement/everything-you-wanted-to-know-about-reps-and-warranties-but-were-afraid-to-ask) (<http://www.divestopedia.com/2/4691/sale-process/purchase-and-sale-agreement/everything-you-wanted-to-know-about-reps-and-warranties-but-were-afraid-to-ask>), and can help the seller navigate the intricacies of the PSA negotiation.

But what happens when the seller confronts an [unbridgeable gap](http://www.divestopedia.com/definition/1065/valuation-gap) (<http://www.divestopedia.com/definition/1065/valuation-gap>) between itself and a [prospective buyer](http://www.divestopedia.com/definition/4583/prospective-buyer-list) (<http://www.divestopedia.com/definition/4583/prospective-buyer-list>) around indemnification issues?

Consider the following example

A business owner is looking to sell its textile company for \$100MM. A potential buyer submits an offer matching the asking price. In addition to the price however, it asks for an escrow of \$10MM to support claims for breaches of seller's [representations and warranties \(R&W\)](http://www.divestopedia.com/definition/889/reps-and-warranties) (<http://www.divestopedia.com/definition/889/reps-and-warranties>). The seller is unwilling to leave such a large amount of money in escrow and declines the offer. After further [negotiations](http://www.divestopedia.com/topic/43/negotiation) (<http://www.divestopedia.com/topic/43/negotiation>), and in exchange for a smaller escrow (\$5MM), the buyer makes a reduced offer of \$90MM. The seller is happy with the smaller escrow, but considers the altered purchase price too low. Negotiations falter and eventually the deal fails.

Negotiations like this on escrow and indemnities occur because the seller, as part of the PSA, makes certain R&W about the condition of the business when the deal is signed. These reps and warranties are essentially assertions of fact - a common one being that the financials of the company have been audited and are in compliance with regulatory standards - which the buyer relies on in [valuing the business](http://www.divestopedia.com/2/858/valuation/valuation-methods/magic-tricks-to-help-you-get-the-valuation-you-want). (<http://www.divestopedia.com/2/858/valuation/valuation-methods/magic-tricks-to-help-you-get-the-valuation-you-want>)

In the event that one of the R&W is inaccurate and such inaccuracy results in a loss post-close, the buyer will seek to recover the loss in value by [making an indemnity claim](http://www.divestopedia.com/definition/4734/your-watch-my-watch-clause) (<http://www.divestopedia.com/definition/4734/your-watch-my-watch-clause>) against the escrow.

R&W Insurance and Its Place in the Transaction Process

R&W insurance steps into this process by providing coverage for liabilities arising from an unknown breach of the R&W by the seller. On the one hand, the seller can backstop its indemnity to the buyer by purchasing R&W insurance in its own name, effectively buying a backstop against an unknown breach. Far more frequently, however the parties will arrange R&W insurance for the benefit of the buyer in lieu all or the better portion of seller's escrow or indemnity, providing seller with a cleaner exit from the deal. Purchase of R&W insurance is done on a designated limit and retention level. The limit is the maximum amount the insurance will pay out in the event of a breach of a representation or warranty, while the retention is the loss which must be borne before the insurance comes into effect.

The process for obtaining this type of insurance is fairly straightforward. Typically, an insurance broker will approach the market on behalf of the seller/buyer with information about the transaction and company. After obtaining quotes, including prices and coverage terms, the client will select the offer that best meets its needs. Then begins a process of underwriting during which the insurer examines the risks of the deal and writes the actual R&W policy. The entire sequence can take a few weeks to perform, but can also be completed on an expedited basis in line with the mechanics of the deal. The carrier's underwriting will consist of a review of the [data room](http://www.divestopedia.com/definition/753/data-room) (<http://www.divestopedia.com/definition/753/data-room>) and, assuming the insured is the buyer, the entire buyer's [due diligence](http://www.divestopedia.com/definition/847/due-diligence) (<http://www.divestopedia.com/definition/847/due-diligence>) reports on the target.

Where R&W Insurance Works/Doesn't Work

For the seller in a transaction, the use of R&W insurance can provide significant benefits, including:

- 1) Lower escrow and indemnities - By placing R&W insurance for a buyer as a proxy for the typical seller indemnity, sellers can shift the risk of unknown breaches to the insurance market for a fixed cost and achieve a greater and more certain return at closing.
- 2) Protecting purchase price erosion - Historically, buyers utilizing R&W insurance unbeknownst to a seller would seek a discount on the purchase price in exchange for limiting the escrow and/or indemnity contained in the PSA. However, a seller who takes the initiative by building R&W insurance into the terms of the PSA can eliminate this arbitrage and level the playing field among all potential purchasers, securing the cleanest exit possible without sacrificing purchase price.

For a buyer, the use of R&W insurance can provide for a more attractive bid to the seller, and the potential to win an asset by providing seller with a cleaner exit than the competition. In today's market, considering the rapid growth in usage of R&W insurance (particularly in the private equity community) over the past 3-4 years, buyers often need to consider the use of R&W insurance simply to keep pace with their competition for a given asset.

Despite the obvious advantages, there are still some challenges associated with the placement of R&W insurance. In general, the economics of R&W insurance seem to make the most sense for targets with an [enterprise value \(EV\)](http://www.divestopedia.com/definition/760/enterprise-value-ev) (<http://www.divestopedia.com/definition/760/enterprise-value-ev>) of approximately 50MM+ (assuming a purchased limit of 10%). While R&W insurance can be placed on deals below that level, and while carriers are attempting to service that end of the market more efficiently, the pricing on such deals may become prohibitively expensive due to minimum premium demands by many carriers.

In addition, risks associated with certain industries are also more difficult to insure, with healthcare

billing risk in the U.S. being one such example. It should also be emphasized that R&W insurance is not a replacement for proper due diligence on a deal. A seller or buyer should continue to negotiate the R&W, prepare disclosure schedules and perform due diligence as though insurance were not present in the deal. In the end, R&W insurance does not eliminate risk, but rather transfers some portion of it to an insurer who will require comfort that the deal has been executed professionally, as though the insurance were not a factor.

Trends in R&W Insurance

As the number of transactions using R&W insurance increases, the terms and prices associated with it will change; while pricing decreased dramatically during the recession years as M&A deals became scarce, leading to renewed interest in the product from many firms, pricing has crept back up a bit as coverage has broadened and demand and usage have increased. As the comfort level with R&W insurance continues to grow among deal professionals and advisors, enterprising sellers understanding the particulars of R&W insurance will be in a favorable position to achieve a better exit for themselves and their businesses, with potentially higher EVs, lower escrows and indemnities, and more control over the negotiation process.

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Matt works as a broker in Aon's Transaction Solutions Group (ATS), which serves as a national resource for Aon's corporate and financial sponsor clients, primarily in connection with allocating risk in mergers and acquisitions. ATS provides brokerage and consulting services around transactional liability insurance products, including representations and warranties insurance, tax liability insurance, contingent liability insurance, and litigation buyout insurance.

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Charles leads the Aon team that serves the needs of clients in Canada with merger and acquisition activity. From due diligence through deal close and post-merger integration, we consult on the critical risk and human capital-related liabilities, synergies and growth opportunities associated with a transaction.

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