



Representations & Warranties Insurance for M&A Transactions

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Agenda

- Overview
- Benefits to Parties
- Key Terms and Process
- Recent Trends
- Other Matters

OVERVIEW

Purposes of Rep & Warranties Insurance

- To protect the insured party against **unintentional** and **unknown** breaches of a seller's or target's representations or warranties in a transaction
- To provide coverage against financial losses due to such breaches of representations and warranties

Common Exclusions

- Known issues
 - Separate insurance products may be available to cover some known issues, such as environmental or tax matters
- Actual **knowledge** of breach by transaction team
- Matters arising or discovered before closing (including post-signing)
- Uninsurable fines and penalties (e.g., SEC fines)
- Benefit plan underwriting
- Purchase price adjustments

Heightened Risk Areas

- Cyber security/data privacy
- Products liability
- Environmental
- Wage and hours laws
- Healthcare (Medicare and Medicaid billing)

BENEFITS TO PARTIES

Benefits for Buyers

- Avoids collection issues
 - May avoid (1) need to chase multiple, individual and/or foreign sellers, (2) credit risk, (3) collection costs and (4) enforcement issues
 - Avoids suing new management team for breach of reps & warranties
 - Protect buyer where indemnity rights don't otherwise exist
 - E.g., in a public company acquisition or seller bankruptcy context
- Protection
 - May provide longer survival period and increased coverage
- Enhance bid in auction
 - Buyer reduces or eliminates insistence on seller indemnity; increases maximum indemnity
 - Provide recourse when no seller indemnity possible

Benefits for Sellers

- Clean exit
 - Avoids or minimizes escrow of sale proceeds
 - Reduces contingent liabilities, enabling distribution of sale proceeds
 - PE funds will seek to distribute to investors full proceeds ASAP
- Limit portfolio company risk
 - Financial seller disposing portfolio company may lack intimate knowledge of potential issues
- Facilitate auction process
 - Sellers may insist bidders accept “no indemnity” or “low indemnity” form of sale agreement coupled with insurance coverage
 - Attract best offers by maximizing indemnification
 - Include reps & warranties insurance as the sole remedy in draft agreements in auctions
 - Facilitates “apples to apples” comparison of bids

Benefits for Both Parties

- Streamlines Negotiation of Purchase Agreement
 - Buyers can require “fulsome” rep and warranty package, providing maximum coverage/recourse (with R&W insurance policy), with Sellers only bearing loss in event of intentional misrepresentation or fraud
 - Given limited recourse to Sellers, they can provide robust reps and warranties with minimal negotiation
 - Indemnity provisions can be minimized or eliminated
 - No need for complicated caps, baskets, procedures, etc.
- Bridges Value Gaps
 - Parties may have differing views on potential losses/risks
 - R&W policy provides “concrete” value/economics, with parties agreeing on policy coverage, retention amount, and sharing of costs

KEY TERMS AND PROCESS

Key Terms

- Duration
 - Typically longer period than survival in purchase agreements
 - 6 years for fundamental reps
 - 3 years for all other reps
- Policy Limits
 - Varies based on transaction, but usually between 10% - 20% of transaction value
- Premium
 - Usually 2-4% of policy limit
 - Plus surplus lines tax and underwriting fee
- Retention Amount/Deductible
 - Typically 1-2% of deal value
 - May also include a lower “drop down” retention amount that applies after the first 12 months
- Materiality Scrape
 - For purposes of determining existence of breach of rep and losses related thereto

Definitions

- Knowledge
 - Generally limited to actual conscious awareness with no duty to inquire
 - No constructive or imputed knowledge
 - Carrier has burden of proving knowledge
- Loss
 - Carriers typically willing to be silent with respect to consequential and multiplied damages (as opposed to having exclusions for those types of damages)

Other Terms

- Subrogation
 - Carriers will waive subrogation rights against sellers
 - Exception = fraud
 - Carriers may agree to limit subrogation rights against customers and suppliers
- Settlements
 - For small settlements by insured and/or settlements by insured with retention, carriers may agree to waive consent rights
- Failure to Comply
 - Policies may contain safe harbor provision, which only permits carrier to deny coverage to the extent carrier is actually/materially prejudiced by an insured's failure to comply

Negotiation Points

- Context
 - In an auction format, Sellers may require Buyer to bear full cost of R&W policy
 - Premium, retention amount, etc.
 - Also up to Buyer to determine amount of coverage and policy terms
 - In negotiated deal, R&W insurance may not be discussed until later stages
 - LOI may contemplate R&W insurance, but not be particular on cost sharing
 - May become another economic negotiating “lever”
- Policy Limit
 - Akin to the “cap” on recoverable losses; a higher limit will result in a higher policy premium
- Premium
 - Can be paid by Buyer, Seller or split
- Retention Amount/Deductible
 - Akin to a “basket” or deductible; similarly, this risk can be borne by Buyer, Seller, or split
 - Can negotiate for Seller to bear first __% of retention, with Buyer bearing remainder

Underwriting Process

Days 1 – 2

Engage broker (earlier in the process is better)

Broker and potential underwriters execute NDAs

Note: Insurers need to understand exclusivity arrangements on transaction (or lack thereof) – timing / financial impact on process

Days 3 – 6

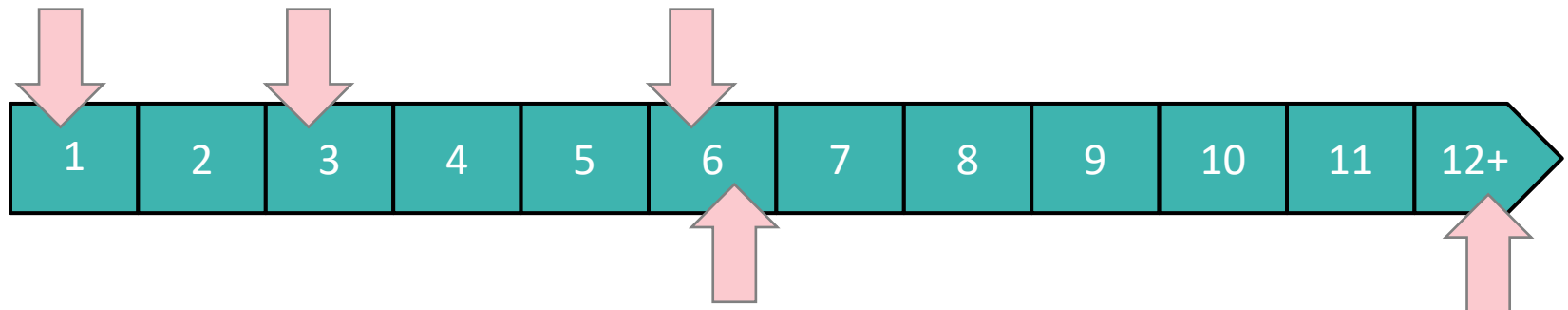
Obtain quotes from underwriters

- Need recent draft acquisition agreement, information memorandum and target's financials
- No cost to obtain quotes

Day 6

Select underwriter

- Broker to discuss pros and cons of proposals
- Insurer diligence fee becomes payable upon entering underwriting (\$25K – \$40K)



Days 6 to 12+

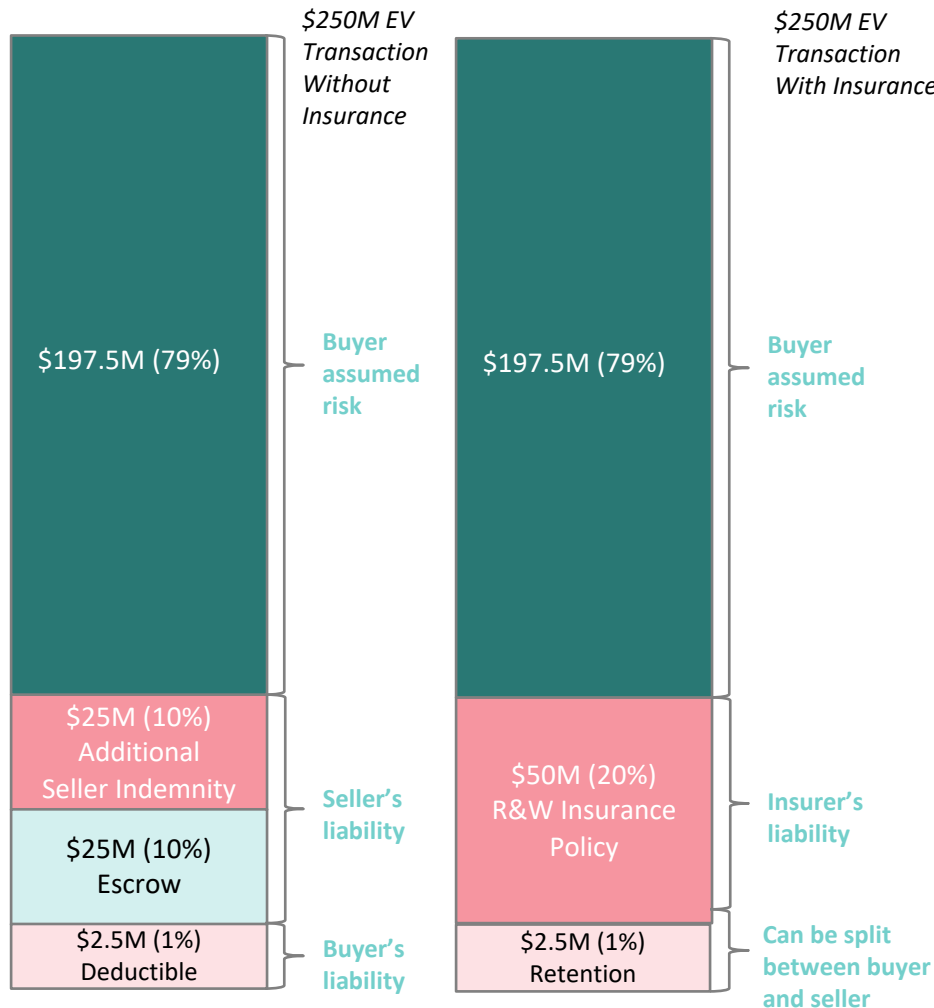
Underwriting of policy

- Underwriter to gain access to data room and legal, financial, tax and other diligence reports (subject to non-reliance letters)
- Conference call with deal team and advisors

Policy negotiations

- Done in parallel with underwriting; outside counsel typically involved

Sample Scenario



Background

- Buyer: US private equity firm
- Target: Distribution company
- Seller: US private equity firm
- Enterprise value: \$250 million

Issue

- Buyer wanted to differentiate its bid in a highly contested auction
- Seller wanted a clean exit at closing to maximize closing date proceeds

Solution

- Buyer-side reps & warranties insurance policy
- Limit: \$50 million
- Total Cost: \$1.5 million
- Policy term: 3 years for general reps / 6 years for fundamental and tax reps

RECENT TRENDS

Significant Growth

2018

- \$13.75 billion in limits / 405 closed deals

2017

- \$8.83 billion in limits / 303 closed deals

2016

- \$6.03 billion in limits / 212 closed deals

2015

- \$4.26 billion in limits / 159 closed deals

2014

- \$2.73 billion in limits / 130 closed deals

2013

- \$1.34 billion in limits / 66 closed deals

2012

- \$1.43 billion in limits / 51 closed deals

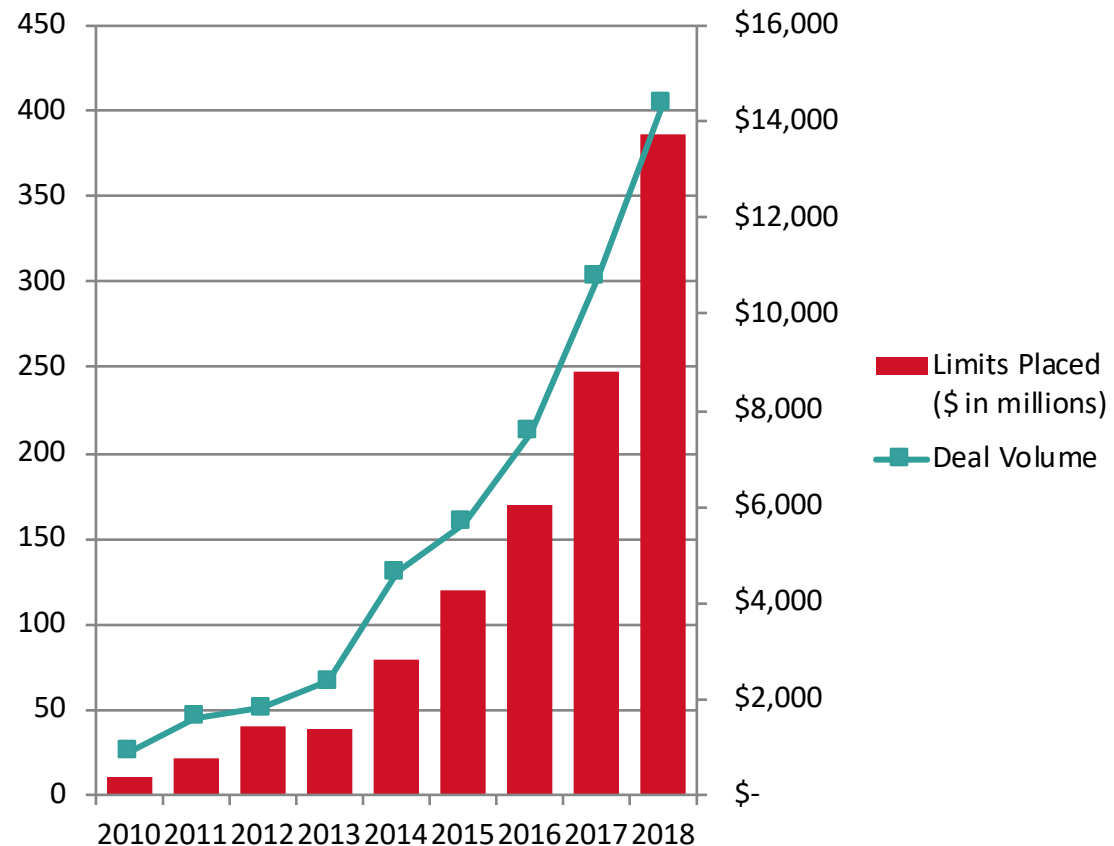
2011

- \$767 million in limits / 45 closed deals

2010

- \$387 million in limits / 25 closed deals

North America Market Statistics (for Marsh only)



Global Market

The market now offers:

- Broader coverage
- Streamlined process
- Increased limits of liability
- Reduced premium rates and deductible levels

Marsh has an estimated
25% global market share

Marsh placed over 1,100
Transactional Risk policies
globally in 2018

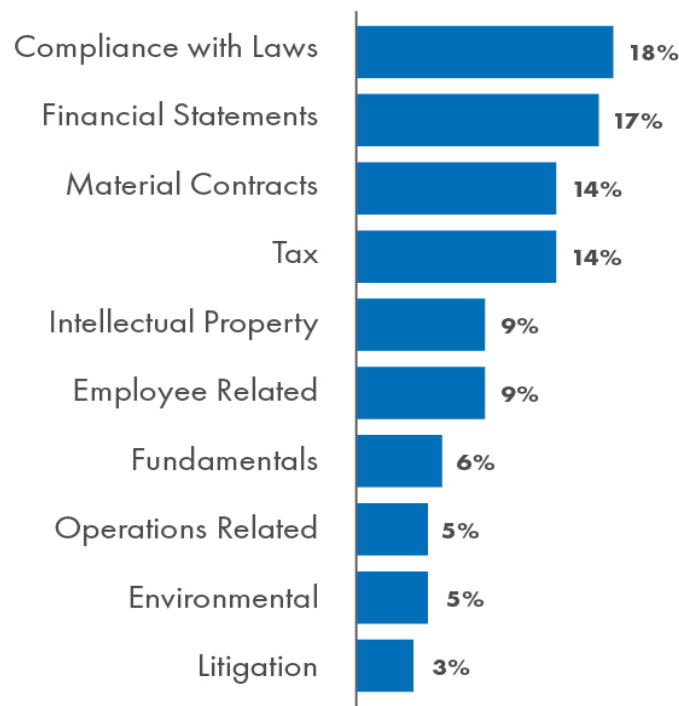
Global Market Statistics for 2018 (Marsh only)

US\$	AMERICAS	EMEA	ASIA PACIFIC	TOTAL
Limits of insurance placed (\$)	13,755,000,000	10,566,000,000	3,575,000,000	27,897,000,000
No. of closed transactions	405	285	99	789
Private equity policies (as % of policies placed)	55%	57%	52%	54%
Corporate policies (as % of policies placed)	45%	43%	48%	46%
Seller-side R&W policies (as % of R&W policies placed)	1%	2%	3%	2%
Buyer-side R&W policies (as % of R&W policies placed)	99%	98%	97%	98%

Frequently Made Claims

Representations relating to financial statements, compliance with laws, material contracts and taxes are the most frequently alleged to have been breached

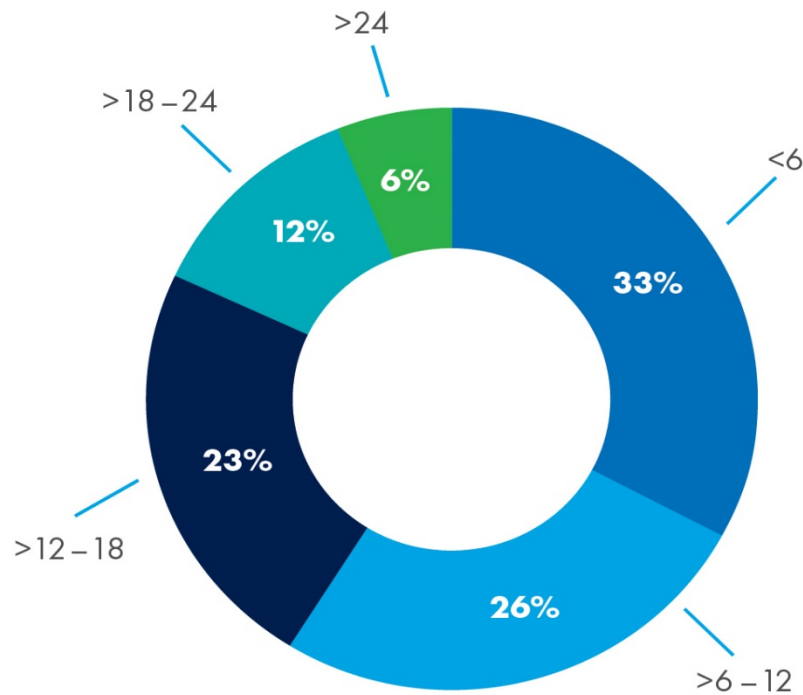
R&W Reported Incidents by Breach Type – Americas



Timing of Claims

More than half of all claim notices are received within the first 12 months of the policy's issuance

**R&W Distribution of Average Claim Report Lags
from Policy Inception Date (in Months)**



Source: AIG Global M&A Claims Study 2018
Based on policies written by AIG between 2011 and 2016



OTHER MATTERS

Tax Insurance

- Covers against financial consequences of an intended tax treatment being disallowed by relevant tax authority in situations where:
 - There is no clear precedence or guidance
 - Transaction economics flowing to parties relies heavily on the tax structure such that investors and/or lenders thereto require comfort that the tax structure and benefits will be respected
 - Tax authority approval (e.g. PLR) is not available or cannot be received in required time frame
 - Potential downside is significant relative to transaction size and the financial model does not allow for “margin for error”

Tax Indemnity Insurance

- Typically occurs in M&A context
- Known tax risks and certain tax attributes are excluded from traditional R&W policy
- Backstops/replaces tax indemnity in SPA
- A separate tax insurance policy provides a holistic insurance solution

Contingent Liability Insurance

- Covers “one-off” identified potential exposures that have not yet crystallized
- Cost, limits and deductibles will vary based on the particular risk
- Three things necessary to insure risk:
 - Quantifiable risk
 - Probability analysis
 - No moral hazard
- Recent examples:
 - Successor liability
 - Specific indemnities
 - Fraudulent conveyance
 - Other legal, legislative or regulatory risks

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Current Responsibilities

- Jodi works in the Private Equity and Mergers and Acquisitions group within Marsh's Financial and Professional Liability Practice. She is an expert in the field of transactional risk insurance, responsible for advising clients on representations and warranties insurance, tax insurance and other insurance products addressing contingent liabilities encountered in M&A transactions.

Experience

- Prior to joining Marsh in 2017, Jodi was a corporate attorney specializing in Mergers and Acquisitions at Kramer Levin Naftalis & Frankel for 14 years, where she represented private equity and strategic buyers and sellers in connection with domestic and cross-border M&A transactions in North America, Europe and Asia. Jodi regularly advised buyers and sellers in the use of representations and warranties insurance, and also served as counsel to a number of underwriters and insurers in connection with the underwriting of representations and warranties insurance policies.

Education

- BA, Psychology, with University Honors, Johns Hopkins University
- JD, University of Pennsylvania Law School

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Practice Overview

- Grant Everett represents public and private companies in a variety of corporate matters. Mr. Everett focuses principally on mergers and acquisitions, including negotiated acquisitions and divestitures as well as equity and debt securities offerings. His practice also focuses on structuring and forming joint ventures and other investment vehicles as well as a variety of cross-border transactions. He also advises clients regarding Exchange Act reporting, stock exchange compliance and corporate governance.
- Mr. Everett's practice includes representation of clients from a broad variety of industries, including oil and gas, technology, media and manufacturing. His practice also includes the representation of management teams and private equity providers, largely in upstream oil and gas projects. He has practiced with Baker Botts for 10 years.

Education

- BA, International Business, *magna cum laude*, Pepperdine University
- JD, *with highest honors*, University of Oklahoma College of Law

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