Insurance for Representations and Warranties

in Mergers and Acquisitions

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Purchasing insurance to transfer some of the risks associated with mergers and acquisitions is becoming more common. An insurance policy is a contract that is meant to transfer certain risks from the policyholder to the insurance company. In an acquisition, representations and warranties insurance (“Reps and Warranties Insurance”) is purchased to transfer the risks arising out of the seller’s breach of what are typically heavily negotiated representations and warranties.

The seller typically agrees to indemnify the buyer for any breach of the seller’s representations and warranties. Sometimes this indemnity obligation is capped, subject to an escrow, holdback or time limit. More buyers, however, are also seeking to reduce their risk by adding Reps and Warranties Insurance along with requiring certain indemnities from the Seller.

Key considerations concerning Reps and Warranties Insurance include the following:

1. The cost. The typical premium charged for Reps and Warranties Insurance is 2% to 3% of the policy limits. Added to these costs are the broker’s commission, state taxes and potentially an underwriting fee. The insurers will also not issue a policy that does not generate at least a six-figure premium. The current trend appears to be the purchase of policies with a policy limit of approximately 10% of the overall purchase price.
2. The retention. Reps and Warranties Insurance policies usually include a retention that is roughly 1% of the purchase price. This means that the policyholder (the buyer) must incur losses equaling at least 1% of the purchase price due to the seller’s breach of its representations and warranties before realizing any recovery under the policy.
3. The exclusions. The adequacy of the policy’s limits needs to be assessed as many of these policies have a limit that is typically 10% of the deal consideration. Other exclusions one typically sees in these policies include no coverage for purchase price adjustments, a breach of warranties and representations of which the buyer had actual knowledge regarding particular deal terms, losses occurring because of breach of the date of closing, and tax-related issues. Some of these policies also exclude coverage for consequential or multiple damages arising out of the seller’s breach. Finally, Reps and Warranties Insurance policies also contain the standard exclusions for liabilities arising out of environmental issues and wage and hour claims. An excess policy may address some of these issues.
4. Recovering under these policies. Like any claim under an insurance policy, the buyer’s tender of a claim under a Reps and Warranties Insurance policy is subject to the insurance company’s claim process. Insurers seek to deny coverage for claims made under these policies on the same grounds they use for other types of policies. Examples include:
* False or incorrect information on the application or that is submitted as part of the application process
* The claim does not fall within the definition of “covered loss”
* The breach was known by the policyholder prior to the purchase of the policy
* The claim is excluded under the policy’s exclusions
* For commercial reasons the insurer determines it will deny the claim

Purchasing Reps and Warranties Insurance can be beneficial if the buyer is reasonably certain that the deal risks the buyer wishes to transfer to the insurance company issuing the policy are in fact transferred. An insurance coverage lawyer should be engaged to review the deal and the proposed policy. This engagement can be performed on a flat fee or not-to-exceed basis by a coverage lawyer with experience in the representation of policyholders in coverage litigation.

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