Gallagher

M&A and PE Portfolio Solutions

Representations and Warranties Insurance

Over the past decade, representations and warranties insurance (RWI) has evolved into a critical dealmaking tool. Once a niche risk-shifting product used in only a handful of transactions each year, the product has now become an indispensable part of deal negotiations; by some estimates, it is used in about 75% of private equity transactions, about 64% of larger strategic transactions and about 20-30% of secondary transactions. RWI is not simply a risk mitigant; it is a means to smoother dealmaking and value maximization.

What is RWI?

RWI protects buyers in a transaction (or, less frequently, sellers) from financial loss resulting from a breach of the representations and warranties the seller has made in a purchase agreement.
The policies are negotiated on a deal-by-deal basis, resulting in bespoke coverage that reflects the specifics of each transaction. The limit of liability, retention (or deductible), specific terms and conditions, and the policy wording itself are negotiable aspects of coverage. Having the right broker is key: sophisticated, thoughtful and informed brokers can help their clients and clients' counsel secure the best and broadest possible RWI coverage and maximize the policy's value.

Benefits of RWI to buyers and sellers

Buyers can	Sellers can
Enhance bidder terms	Release capital and distributions
Increase indemnification and survival periods	Alleviate negotiation of representations
Protect management and rollover sellers	Safeguard buyer relationships
Satisfy lenders and investment committees	Reduce residual liability

Policy features

While buyers often obtain 10% of the transaction's total enterprise value in RWI limit, mirroring the standard amount of a traditional escrow, an experienced broker will work with a buyer to tailor the amount of coverage to the particular risks and considerations of the deal. The RWI policy has a few key features:

- **Covered representations:** Representations given by the seller in the transaction agreement.
- **Standard exclusions:** Certain exclusions are standard to every policy, regardless of the type of deal or the target company's operations (for example: matters known to the buyer as of inception; asbestos and certain pollutants like PCBs; and the availability or applicability of net operating losses, to name a few).
- **Deal-specific exclusions:** These are exclusions that are specific to the target or the deal and are either flagged at the initial insurance quote stage or are identified in the course of underwriting. Experienced brokers, counsel and buyers will negotiate the scope and applicability of any such exclusions.
- **Period of insurance:** The typical policy term lasts three years for general representations and six for fundamental representations, although most insurers will cover fundamental representations for seven years with no additional charge, and other coverage permutations may be possible for an additional premium.
- **Insured limit:** The limit will vary by deal, and there is over $1 billion in capacity in the RWI market.
- **Retention:** A single, aggregate retention, expressed as a percentage of the enterprise value. There may be no retention or a reduced retention for certain fundamental representations. The retention typically drops down to a lower amount at 12 months after closing.
- **Premium:** This will vary by deal and is driven by multiple factors, including the specifics of the transaction and target and the current macroeconomic environment.

Process and timing

The ideal time to engage the Gallagher RWI team is approximately a month before the signing of a transaction and even earlier if possible, particularly if there is a need for human capital or insurance due diligence. This allows plenty of time to solicit insurance quotes, negotiate the best initial terms, select a carrier or carriers to underwrite the transaction and move through the underwriting process to ensure a policy is finalized and ready to incept at signing. However, we (and the insurance market) moves on deal timing: if need be, we can place a robust policy in a matter of days!

Claims

Claims are the most critical consideration when obtaining RWI. There are claims noticed on around 20% of all RWI policies (though not all result in a payable loss), most frequently with respect to the financial statements, material customer, tax and compliance with laws representations. An insurer's historical claims handling and payments should be a key consideration when a deal is marketed to the insurers and when a carrier is selected. A broker's ability to advise on this topic and to support a client and push for a resolution in the event a claim materializes is perhaps the broker's single most important value-add.

State of the market

There are now around thirty different providers of RWI for US transactions. As noted above, pricing is driven by a number of factors, including the size and structure of the transaction, the operations of the target company and the parties involved. In recent years, however, the main factor driving pricing has been the sluggish M&A market, which has catalyzed increased competition among carriers and driven pricing to all-time lows. However, as M&A activity has begun to rebound, we are seeing something of a mean reversion in RWI premiums: prices are currently hovering around or slightly above a 3% rate on line (that is, the premium expressed as a percentage of the limit sought — i.e., $300,000 for $10,000,000 of coverage) on average. Certain more challenging sectors, such as healthcare, are seeing faster rate increases as some markets restrict their underwriting appetite due to claims activity and underwriting experience. A well-informed broker will ensure that a buyer is offered the best possible pricing and coverage for a deal and be able to negotiate among carriers to ensure the most competitive rates.

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