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Market Conditions

JANUARY 2018

Representations and Warranties Insurance

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INTRODUCTION

Representations and Warranties (R&W) insurance was designed nearly twenty years ago to provide insurance coverage for breaches of representations and warranties by the seller in a purchase agreement. A relatively obscure product with fluctuating popularity until 2011, policy placement in mergers and acquisitions (M&A) transactions continues to increase significantly each year as buyers, sellers and their outside counsel have become more comfortable using the product to supplement or even replace seller indemnity obligations by insuring all (or most) of the representations made within the purchase agreement. In fact, many deal attorneys now believe that R&W insurance is no longer optional.

BUYER & SELLER BENEFITS

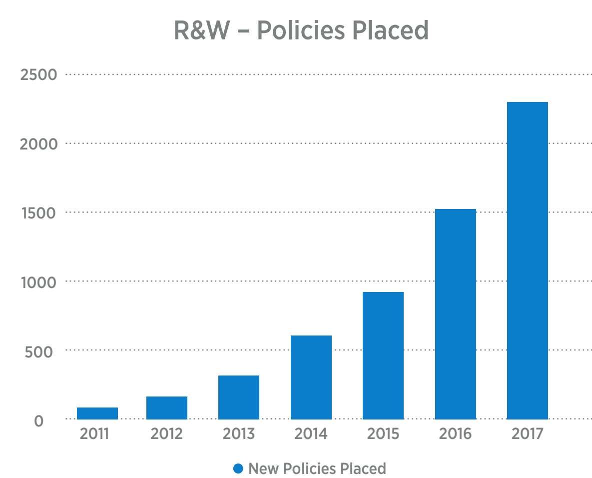
Each side of an M&A transaction can benefit from the use of R&W insurance. For sellers, not only does the policy safeguard sales proceeds, a policy can expedite the sale by eliminating obstacles such as protracted indemnification negotiations over baskets, caps and survival periods. A policy also can potentially increase the purchase price by significantly reducing or eliminating escrow altogether and subsequently allowing a seller to distribute most or all of the proceeds to investors. Buyers certainly find reduced counterparty risk and security in their returns with the knowledge that their investment is backed by an insurance company rather than a seller that could be looking to distribute proceeds or make an exit. Moreover, policies provide enhanced protection from breaches by supplementing the survival period typically provided under a purchase agreement. In the private equity world or in a competitive bid process, buyers can also separate themselves from the field with a bid that has a smaller escrow or no escrow at all. Finally, for deals where founders and key employees are looking to stay on board following an acquisition, buyers can seek coverage under the policy rather than indemnification from their new business partners.

ECONOMICS

The underlying economics of R&W insurance has stabilized as the marketplace continues to evolve and become more competitive. Policies typically have a liability limit between 10% and 20% of enterprise value, with larger deals seeing lower limits as a percentage of enterprise value and vice versa. Most often, total enterprise value ranges from $100 million to $750 million; however, there has been growth toward both ends of the spectrum. Premium is a function of the limit purchased and is generally priced between 3% and 4% of the limit on a multi-year policy. Although premium initially ranged as high as 4% to 8% of the limit purchased, it has dropped substantially due to increased market competition. The current 3% to 4% range is also tied to retention. Each policy carries a retention, also known as a deductible, of somewhere between 1% and 2% of enterprise value. Retentions can be split between the buyer and seller pursuant to the terms of the purchase agreement. Although carriers prefer to have sellers retain some portion of the retention, in some circumstances deals can be structured to eliminate all seller indemnification for additional premium. Insureds can also expect to remit a nonrefundable underwriting fee in the amount of $25,000 to $50,000. The fee is largely dependent on the size and complexity of the transaction.

ANALYTICS

M&A activity has been robust over the last ten years and the solicitation and placement of R&W insurance has virtually exploded during that same time. In 2016, total limits were deployed (combined primary and excess) in the amount of $14.77 billion and generated $526.5 million in premium. In fact, the number of R&W insurance policies placed in 2017 was north of two thousand.



Source: carrier interviews

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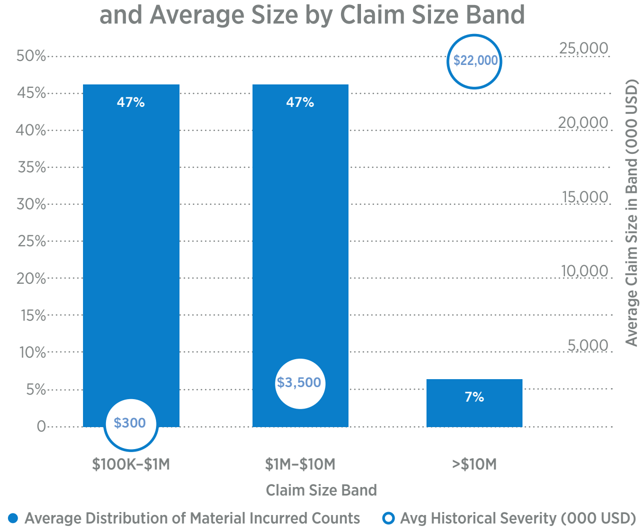
Despite this explosive growth, the overall number of transactions that sought R&W insurance is still approaching only 20% domestically. Interestingly, R&W insurance seems to be the norm overseas with nearly 60% of the deals in the UK and more than 90% in Australia using the product in their M&A transactions. Given the fact that many transactional attorneys now believe R&W insurance is a necessary component of any deal, the domestic market should continue to expand substantially in the years to come.

CLAIMS DATA

Increased policy issuance along with a better understanding of product coverage has led to a meaningful jump in claims activity. Although claims-related data was not widely available until recently, we note that for the period from 2011 to 2014, claims activity averaged around 14% and increased to more than 20% after adding 2015 claims data into the mix. Claims frequency tends to rise as enterprise value increases, most likely due to increasingly complex transactions and an inability to uncover every potential pitfall during due diligence and underwriting.

R&W Material Claims – Distribution of Counts and Average Size by Claim Size Band

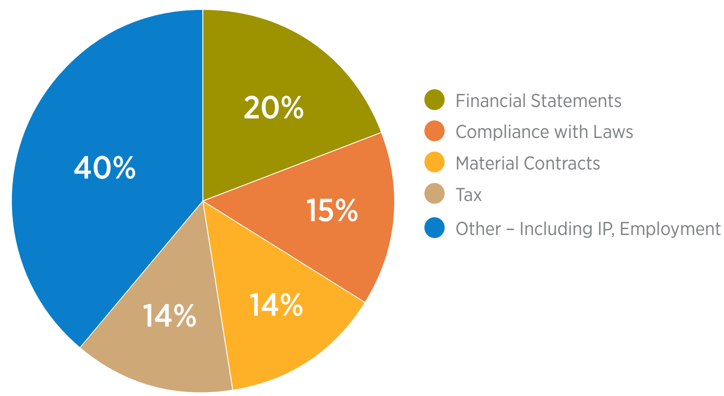


Source: 2017 AIG Claims Study

Also notable is the fact that more than 50% of claims are made during the first 12 months of coverage. This has enabled carriers to issue retention dropdowns following expiration of the same period and in alignment with the escrow release terms of the purchase agreement. While breaches of representations related to financial statements, taxes and compliance with laws/regulations are the most commonly alleged, there has been a substantial amount of claims on other representations and warranties as well.

With respect to claim severity, the large majority falls under a threshold of $10 million; however, approximately 7% of claims are greater than that. It will be interesting to monitor claims data over the next few years as more and more R&W insurance policies are issued.

R&W – Breaches



Source: 2017 AIG Claims Study

DIFFERENTIATION AND GROWTH

As the market for R&W insurance matures, we are witnessing increased capacity and heightened competition between the carriers. Policy language and exclusions were frequently the sole differentiators. Today, insurers are beginning to write business on industry specific deals, such as health care, where it was initially avoided. They are introducing innovative tax products to address standard exclusions and providing additional coverage enhancements with respect to indirect and consequential damages that were previously unavailable. We are also seeing zero seller indemnity deals with greater frequency. Law firms are bringing increased competition to the table too, pushing the limits of coverage via proprietary R&W insurance policy forms. At the end of the day, however, the most important differentiator could be how each carrier handles their claims. That will go a long way to determine where brokers, buyers and outside counsel ultimately feel most comfortable placing their business.

Aaron M. Zeid, Esq. is Area Vice President for Gallagher Specialty Products. Aaron provides leadership and subject matter expertise to the Transactional Risk team and is a specialist in the areas of Representations and Warranties Coverage, Tax Liability, and Contingent Liability. For additional information, please contact Aaron at aaron_zeid@ajg.com, call your local Gallagher representative or visit www.ajg.com/mlp.