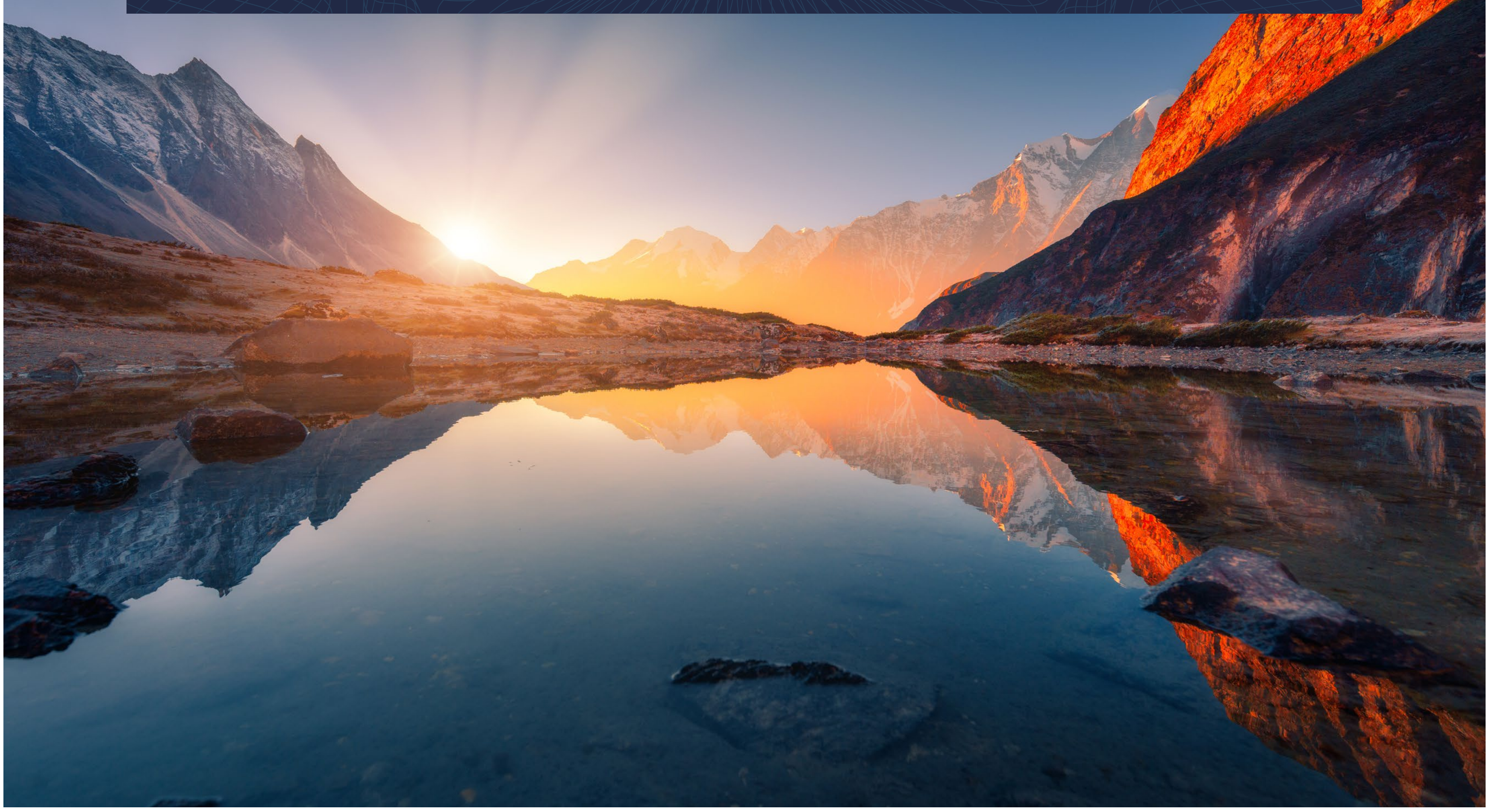
WOODRUFF SAWYER

Guide to Representations & Warranties Insurance



GET STARTED

The use of Representation and Warranties Insurance (RWI or R&W) has become increasingly mainstream; it is utilized in an estimated 75% of private equity transactions and 64% of the time by larger strategic acquirers. Woodruff Sawyer's R&W team presents this comprehensive look at this facet of coverage.

9 Reasons to Use Representations & Warranties Insurance

While R&W has been around for some time, it has only gained popularity in the last five or six years. These days, you can obtain broader coverage with better pricing, and the process is more streamlined than when the product first came out. While that has helped increase use of this insurance product, the following benefits demonstrate why R&W appeals more than ever to today's market. RWI helps you:

1. **Close the Transaction More Quickly:** R&W insurance can reduce or remove escrow for an M&A transaction, which allows the seller to either reinvest, realize, or more quickly distribute the proceeds they receive. It also allows the buyer to offer a quicker, cleaner process, which matters a great deal in a sellers' market.

2. **Achieve a Smooth Transition:** Having spent a vast amount of time and money acquiring a management team as part of the M&A process, no buyer wants to fight an escrow battle or file suit against the seller. A buy-side policy can be written so the buyer can be made whole without attacking their new people.

3. **Mitigate Concern Surrounding Solvency of Seller:** If the seller is a smaller business that will cease to exist after the deal is done, there may not be an accountable party to pursue if/when a claim arises. A seller who backs up their promises with an A+ rated policy removes that concern.

4. **Negotiate Your Terms:** As any seasoned practitioner of M&A will tell you, negotiating the indemnification is often the most challenging and time-consuming aspect of a transaction. Using insurance as a security backstop against any breaches or unforeseen costs makes for a smoother and often shorter negotiation process.

5. **Vet the Transaction:** While it may concern you to bring a third party into a transaction, R&W underwriters genuinely have your best interests at heart. Neither party wants a problem post close. A team that provides an impartial review of previous due diligence is a valuable contributor to the process.

6. **Choose Your Protection:** A buy-side policy allows the buyer to purchase a limit of their choosing without needing the seller to agree to the same amount of liability.

7. **Gain Peace of Mind:** Many strategic buyers are buying assets with the intention of expanding their reach or offering. This strategy can mean entering territory where they have less experience. An R&W policy helps protect the buyer from what they don't know.

8. **Present Competitively in an Auction:** Several years ago, private equity firms started buying R&W coverage because it helped them win bids. Increasingly, an offer to buy R&W is becoming table stakes in a transaction. A lack of understanding of the product could be costly for bidders.

9. **Best Practice in Corporate Governance:** Litigation around M&A transactions is practically continuous. Having a strong RWI policy with robust limits can be a bulwark against claims of inadequate diligence and gives the buyer a chance to be made whole in the event of a problem arising post close.

What is Representations & Warranties Insurance?

R&W insurance is essentially a breach of contract coverage designed to enhance or replace the indemnification given by the seller to the buyer. In short, once the ink has dried on the merger or acquisition deal, R&W covers some of the unforeseen costs caused by any breaches of the seller's representations, whether it involves issues with their customer contracts, employment agreements, or the super-secret recipe of their product (i.e., intellectual property or "IP").

The indemnity package is usually the most contentious part of any merger or acquisition negotiation. R&W steps in to eliminate contention and provide everyone with a cleaner, faster, and safer deal.

Here is a snapshot of the underwriting market for RWI, followed by details on who uses it and for what purposes.

R&W Insurance: The Current Underwriting Market

If your deal size is...	\$50 million–\$400 million	\$400 million–\$900 million	\$1 billion +
Your retention is typically...	1% ↓ 0.5%	0.75% ↓ 0.5%	0.5%

Who uses insurance in an M&A transaction?

- Corporate buyers who want the ease RWI brings to the transaction and are seeking to maximize their attractiveness to potential sellers
- Private equity firms looking to maintain strong relationships with management post close
- Private equity firms looking to close a fund and/or mitigate clawback risk
- Public companies looking to protect the balance sheet after they divest a subsidiary
- Private sellers looking for safeguards in a sale

What problems can RWI address and how?

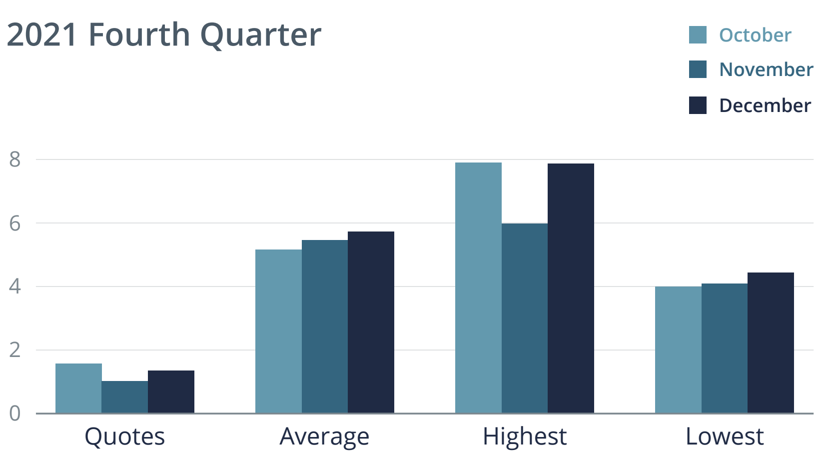
- Overcoming obstacles in the negotiation of the transaction
- Extending the life of the warranty
- Extending the dollar amount of protection
- Bridging the gap between the desires of the seller and the buyer
- Partially funding shortfalls in the escrow; may obtain better investment returns and/or hasten access to funds

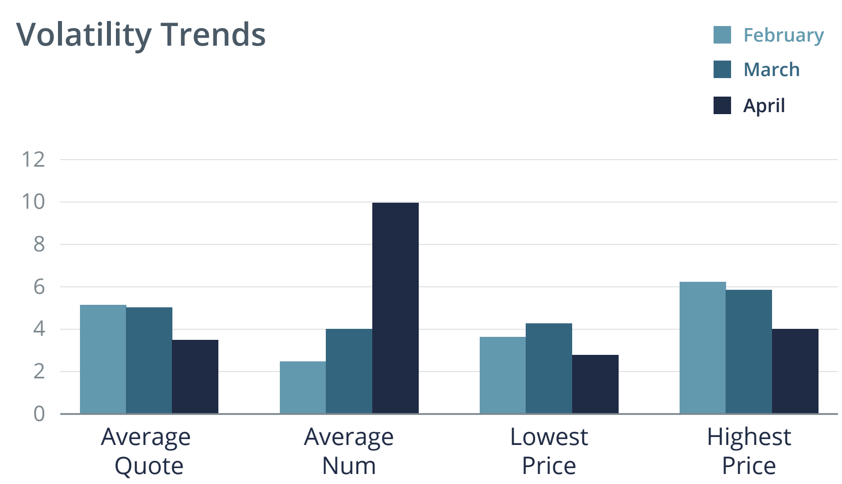
What are key R&W insurance factors?

- **Markets:** There are approximately 23 markets with a wide variety of appetites, experience, claims-paying history, and international capabilities. Picking the right one is a nuanced and deal-specific task.
- **Coverage:** Each contract is individually negotiated.
- **Pricing Parameters:** This is dependent on the size of retention/escrow and other deal factors; 3%–4% of coverage limits are required (e.g., $10 million at $300,000–$400,000). The market has gone through some severe price fluctuations in the last year, so keeping up to date with pricing is an ongoing process.
- **Retention:** This is customized to the deal; usually 1% of transactions, dropping down to 0.5% after 12 months.
- **Underwriting Fee:** There is typically a $30,000–$45,000 non-refundable fee due at the time of legal review.

Changes in Premiums from 2021 to 2022

The changes we saw at the end of last year are holding firm in the beginning of this year, with standard rates now running 3%–4% of the limit bought. To see a deeper analysis of the figures, read our blog post, [Reps & Warranties: Spring 2022 Trends to Watch].





Overall, the news was very good for our clients and those needing reps and warranties insurance. The average number of quotes went through the roof and the premium prices we are seeing are on par with the beginning of 2021, if not slightly more competitive.

The lowest quote we saw was 2.98%, a return to early last year in terms of pricing. Unlike last month this low number was not as much of an outlier as previously seen. We are pretty much in the 3.5–4.5% range for most quotes right now.

The average quote was down from 5.1% to 3.5% which is a substantial decrease and shows the market's ability to quickly adapt to changing circumstances. To put this in context, if you bought a $10 million policy in March you would have paid roughly $510,000 and if you bought that same policy in April, it was more likely to cost $350,000.

Average Quote: **3.5%**	Average Number of Quotes: **10**
Lowest: **2.98%**	Highest: **4%**

Key Elements of an R&W Policy

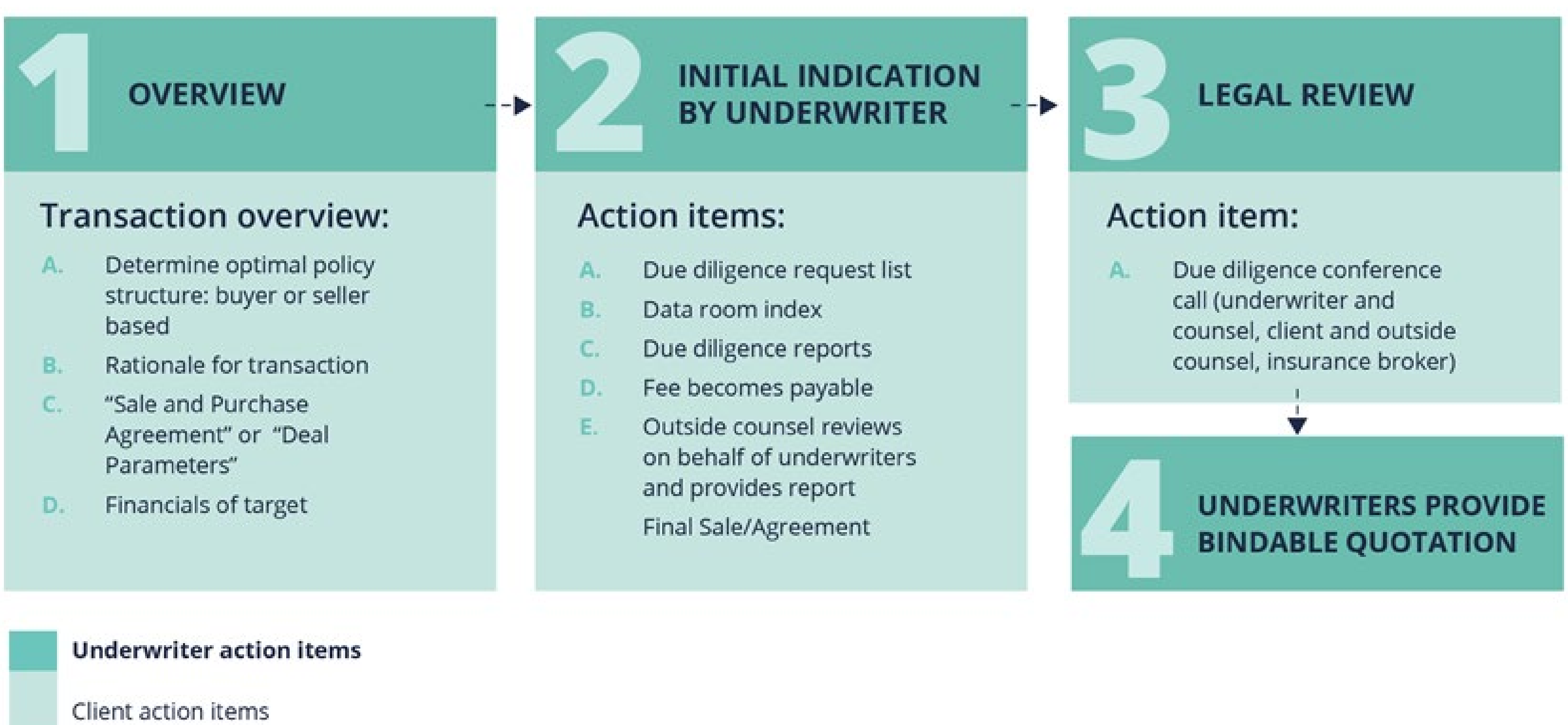
Now let's walk through how R&W insurance works, how it's placed, and what it costs. We will also look at likely developments in the coming year.

1. The Typical Policyholder

While either buyer or seller can be the insured, 97% of the policies placed are buy-side, protecting the buyer from any breaches of the seller's representations. Here are five buy-side details that provide more explanation:

1. Buy-side policies have additional fraud coverage that sell-side policies can't provide.
2. The insured buyer can pick a coverage limit and survival period (i.e., the period for which the policy is in place) beyond what the seller is willing to give.
3. With this coverage, the buyer can avoid suing their newly acquired management team. Should any breaches or misrepresentations come up, they can go directly to the carrier.
4. Buy-side policies allow the buyer to offer lower escrows or more competitive terms in an auction.
5. The insurance can replace distressed company indemnification with A+ rated indemnification.

For more information on buy-side versus sell-side, read our blog post, Buy-Side vs. Sell-Side Policies—Which is Best for You? Part 1 and the accompanying Part 2 post.



2. How Underwriters Assess the M&A Risk

When drawing up the R&W policy, the underwriters evaluate:

- The nature of the sale purchase agreement (SPA) terms and conditions. Examples of this include the definition of loss with regard to multiples and consequential damage language, single or full materiality scrapes, and sandbagging language. Underwriters prefer language that is not strongly in favor of either buyer or seller.
- The nature of the specific warranties being given in the context of the transaction. For instance, IP warranties will be scrutinized more specifically in a tech deal than a manufacturing one.
- The quality of the due diligence. Underwriters wish to provide coverage for the unknown, so they are looking to "diligence the diligence."

3. Exclusions

While the insurance is designed to cover all warranties, certain exclusions are standard:

- Forward-looking warranties (e.g., sales projections, etc.)
- Purchase price adjustments
- The availability or usability of net operating losses or R&D tax credits
- Areas of coverage that are difficult to get, such as FCPA violations, union activity, underfunding of pensions, wage and hour violations, etc.
- Known issues

4. Placement Process and Timing for Coverage

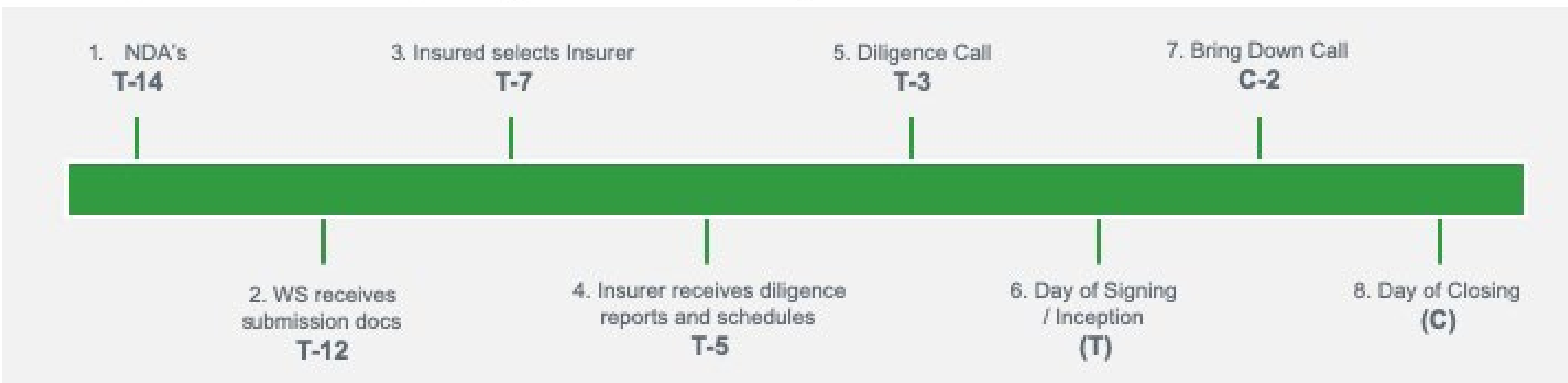
Placing R&W coverage is a two-part process:

- **Initial non-binding indication occurs one week** after receiving the target financials, draft sale and purchase agreement, and any information memorandum that has been prepared by the seller. Underwriters provide initial indications on premium, retention, areas of concern, or heightened risk. Also, it costs nothing.
- **Underwriting requires a $30,000–$45,000 upfront "diligence fee."** Underwriters and their counsel are granted access to the data room and begin reviewing the diligence reports and the disclosure schedules. It involves a two- to three-hour diligence call with underwriters, deal team members, and third-party diligence providers. Twenty-four hours after the call, a draft policy and any follow-up questions will be provided. It doesn't make sense to start underwriting before the diligence is mostly complete and a draft disclosure letter has been produced.

Let's break that down a little more and see what it looks like in terms of how it fits into the deal flow. Note: "DS" is day of signing and "DC" is day of closing; therefore, all the other initials refer to how many days before those events take place. For example, "DS-12" means that 12 days before signing is when something needs to happen.

Securing R&W Insurance within the Deal Flow Timeline:

Step-by-Step Woodruff Sawyer Process



1. Woodruff Sawyer sends NDA to market for execution, reverts with any redlines.
2. Insured sends Woodruff Sawyer the following: (i) draft agreement; (ii) target financials; and (iii) CIM/investor presentation. Woodruff Sawyer prepares submission and sends to the market.
3. Woodruff Sawyer sends proposal to Insured. The proposal includes all markets approached, all prices quoted, and a line-by-line breakdown of comparison between the three most competitive offers. Insured selects insurer with which to proceed.
4. Once NRLs are executed, Insured sends Woodruff Sawyer all diligence reports, the most up-to-date SPA, and a draft of the disclosure schedules. Woodruff Sawyer schedules the diligence call.
5. Diligence call with Insured, insurer, and advisors. Insurer sends follow-up questions and initial draft of the policy after the call.
6. Insured sends Woodruff Sawyer: (i) signed/dated inception NCD; (ii) execution copy of the agreement; (iii) execution copy of the schedules; and (iv) bind order. Coverage is bound.
7. Woodruff Sawyer schedules bring down call with Insured and the insurer.
8. Insured sends Woodruff Sawyer signed/dated Closing NCD. Post-close, final policy issued once (i) data room; (ii) closing volume; and (iii) premium are received.

5. How Pricing is Determined

- Risk retention is expressed as a percentage of overall transaction size. The minimum for mid-size deals is 1% of the transaction, meaning a $100 million transaction has a minimum $1 million retention. For larger deals, above $500 million in EV, it's more common to see a 0.75% retention, which can be in the form of a seller's escrow, the buyer's deductible, or a combination of the two. This drops down to 0.5% after 12 months, regardless of the size of the transaction.
- Premium is expressed as a percentage of the limit of coverage bought and is not related to transaction size. Currently, premiums are ranging from 3%–4% of the limitation of coverage. For example, a $10 million limit would mean a $300,000–$400,000 one-time payment for a six-year policy. It's worth noting that currently, minimum premiums are running around $150,000, so we generally don't recommend this product if the insured is seeking less than $5 million of coverage.

For more information, see our blog post, "Reps and Warranties —Who Pays for What?"

> Read our 2022 Private Equity and M&A *Looking Ahead Guide* for expert insight, advice, and predictions for the mergers and acquisitions and private equity landscapes in 2022

Underwriters in the early days of COVID-19 were seeking broad exclusions to cover any possible complication due to the pandemic. This changed as the pandemic became more of a known issue and underwriting became more focused. In many cases, it is now something that doesn't automatically have an exclusion at all.

We are seeing a quicker move to this more refined approach with the Russian invasion of Ukraine, and, for the most part, exclusionary language is only being applied where it is relevant.

"Underwriting to risk" exclusions, such as the failure to provide contracted services or goods due to an inability to obtain raw materials are becoming more common, geared specifically to events that affect the supplier and customer contracts.

5 Main R&W Exclusions

R&W insurance is continually evolving. There are four buckets of exclusions you generally find in a policy, as well as one common practice that functions similarly to an exclusion.

1. Conduct/Behavior Exclusions

The buyer is required to sign a "no claims" declaration at the start of a policy. If they make a false statement about what they know, that could potentially nullify any claim related to that fraudulent statement, if not the entire policy. Crooks beware, though: it's worth noting that if a buyer is the insured, they are protected against any fraud by the seller but not against their own fraud.

A standard exclusion on a policy would be "any issue known prior to signing/closing," or a similar version of that. Defining and interpreting this exclusion is a vital issue, and its breadth is highly dependent on the specifics of the language.

For instance, let's say there is a piece of litigation related to licensing, and further diligence proves this to be an isolated incident. It would be reasonable to exclude that piece of litigation specifically but not licensing as a whole.

On the other hand, if diligence uncovered that this one piece of litigation was the tip of the iceberg, and the target company had a history of failing to apply for proper licenses, then the whole subject of licensing might be excluded.

2. Standard Exclusions

Net Operating Losses and Tax Credits
Net operating losses and tax credits have been an exclusion for a long time, although we have recently seen some shift in its application. This exclusion can now be dependent on the nature of the target and the amount of diligence around the area. Tax indemnity policies are also available to cover this more specifically if a favorable opinion has been written.

Wage and Hour
Long a standard exclusion, we're also seeing movement toward a more "case-by-case" attitude among underwriters. For example, we are more likely to see this being applied to a deal in the retail space than in the software space.

Forward-Looking Warranties
While this remains in full force as an exclusion, we have seen a shift of onus. We now expect underwriters to draw attention ahead of time to those warranties which they believe have a forward-looking element, rather than having this be a potential guessing game.

Underfunding of Pensions
This remains a standard exclusion.

3. Deal-Specific Exclusions

Deal-specific exclusions refer to specific known issues or problems inherent in the industry for which underwriters will not accept liability, such as Medicare/Medicaid in healthcare (although it is increasingly possible to get coverage in this area) or FCPA in construction.

As with all exclusions, the tightness of the language is key and, as discussed above, getting granular on known issues is vitally important.

Try to identify the kind of breaches you are most likely to have—whether it's intellectual property (IP), cyber concerns, or environmental—to make sure your organization focuses their diligence to aid in removing those exclusions from the policy.

4. World Event Exclusions

In early March 2020, exclusions related to COVID-19 (including any resulting COVID-19 sickness, SARS-CoV-2, or any mutation or variation thereof) started showing up in R&W policies.

From initially broad language that sought to cover any loss even vaguely attributable to COVID-19, the language has evolved to exclude any losses directly attributable to the failure to protect employees, directors, customers, suppliers, and other related parties from the transmission of COVID-19.

Also, there has been a trend toward interim COVID-19 exclusions included at the time of signing but removed once the deal closes. Circumstances that would be favorable to the removal of the COVID-19 exclusion at closing include:

1. The extent of the continued impact of COVID-19 on the company
2. The nature of the discussions between buyer and seller relating to the impact of COVID-19 on the target's business in the interim period
3. A list of instances of COVID-19 cases or illnesses at the target
4. The nature of any concerns expressed by the target's customers or suppliers about meeting targets or maintaining expected activity levels..

In part, this is a response to a shift in attitude, forcing underwriters to justify why an exclusion should be in the policy rather than leaving the onus on the client/broker to prove why it should not. We expect to see this continue into 2022.

COVID-19 had a seismic impact across every aspect of the global economy, and its lasting impact remains to be determined. The industry continues to pivot to stay commercial during an unprecedented economic climate that changes weekly.

Russia and Ukraine

Underwriters have taken a less draconian approach to the Russian invasion of Ukraine. Although we saw some blanket exclusions early on, a more nuanced approach is the norm.

The Impact of the Russian Invasion of Ukraine on the Reps and Warranties Insurance Market

Read more for detailed info into the impact of this conflict on RWI diligence, exclusionary language, and sale and purchase agreement (SPA) drafting.

5. Deemed Deleted/Altered Language

This is not, strictly speaking, an exclusion, but it functions in much the same way. We are seeing an increase in deemed deleted/altered language. In this way, the underwriter can take a scalpel instead of a hammer to a particular rep or warranty rather than excluding the whole thing. A good example would be the addition of a knowledge qualifier so that a rep read “to the knowledge of the seller” rather than as a flat rep. Obviously this would only be for the purposes of the policy and wouldn’t impact the agreement at all.

Structuring Your Program In Different Ways

We've talked about standard retentions and premiums, but what if you want something a little different?

High Retention/Deductible

You can certainly save serious premium dollars if you are willing to take on a much higher deductible. In certain tech deals where IP was a primary concern, we have found more sellers willing to have a high-cash deductible for a limited time. Even if it's only for a year, a higher deductible will save a considerable amount of premium.

Fundamentals Only

Fundamental warranties are a little different from general warranties. On the simplest level, they cover ownership and ability to sell. In other words, a breach of fundamental warranties would likely result in a catastrophic/total loss, as the buyer has bought something the seller was not legally entitled to sell.

However, these are rarely breached and usually well documented during the due diligence phase. As a result, coverage for only the fundamentals is substantially less expensive. Insureds typically use this approach when they are comfortable with the general representations but require certainty with the fundamentals.

We have seen a trend to include several items within fundamentals, such as IP, employee matters, tax, etc., which changes the nature of the risk and broadens it considerably. The price savings will be significantly reduced as a result.

Time Escrows

Another way to save substantially on the premium is through the concept of the time escrow. In this case, you structure the deal with a 10% cash escrow, which is returned after 12 months. The insurance is structured to only kick in a year later once the cash escrow has been returned. Any claims pending against the escrow will be excluded from the policy. Still, it's a way of maintaining the escrow's value while giving relief to the seller at lower premiums.

Choosing Limits

One question we often hear is: “How much do people generally buy?” The answer to that varies greatly, depending on the size and nature of the deal. We also look at the question: “What’s the smallest amount of coverage that makes sense and will that change?”

Currently, the average limit of insurance is roughly 10% of the overall transaction size. So, in a $100 million transaction, a $10 million limit would be the average. However, statistics can oversimplify, and the purchased limit varies from deal to deal.

There are two things to consider:

1. **The nature of the deal:** In a standard deal, the 10% rule is reasonable. The choice of a limit is often determined by what the buyer would have considered an ideal escrow amount. This is not the case, for instance, in an IP-heavy technology deal where a failure of the IP representation could decimate the value of the entire transaction. Such reps are often considered fundamental, and a much higher percentage limit may be sought to reflect this higher level of potential damage.
2. **The size of the deal:** If a deal is on the larger end (over $750 million), it’s entirely possible that the insured amount may be smaller than 10%, because even 5% still represents a large enough dollar amount to be material to any likely breach.

Deciding upon the appropriate limit is based on the specifics of your deal; there is no one-size-fits-all answer. This is another good reason to make sure your broker has experience with a broad range of deal sizes and industries.

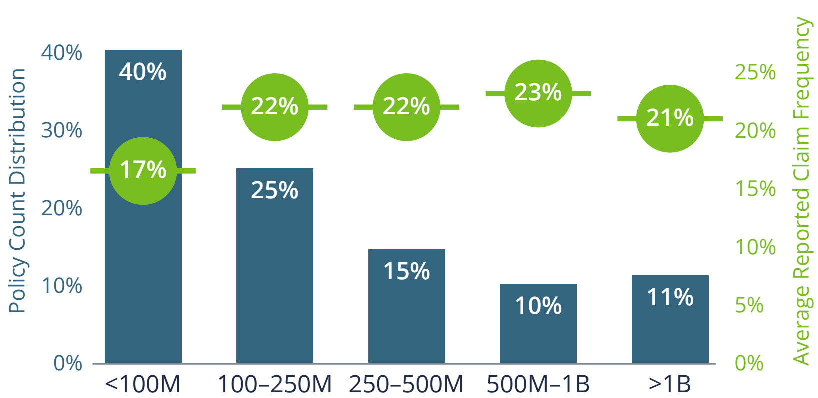
Does RWI Pay Claims?

The most important part of any policy is how it reacts in a claims situation.

In August 2020, Lowenstein Sandler published survey results showing that 87% of respondents received at least a partial payment for all R&W claims that exceeded the self-insured retention. However, a large percentage of the claims resulted in a loss that fell entirely within the retention amount set in the policy, typically 0.75%–1% of the enterprise value.

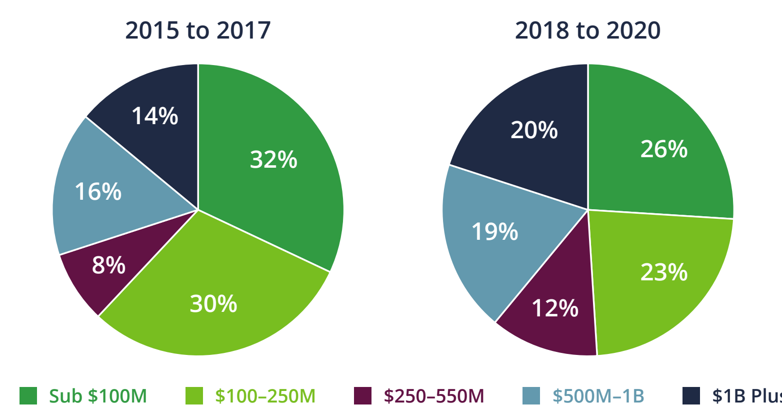
Both Liberty and AIG publish annual reports on their claims' statistics. What's interesting is how similar their statistics turn out to be.

2021 Fourth Quarter



Source: AIG

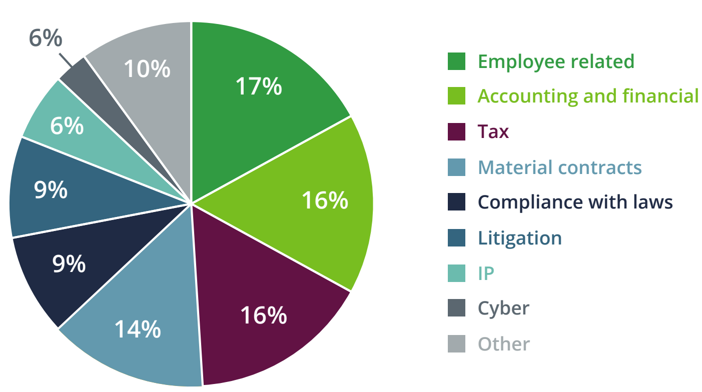
Notification Breakdown by Deal Size



Source: Liberty

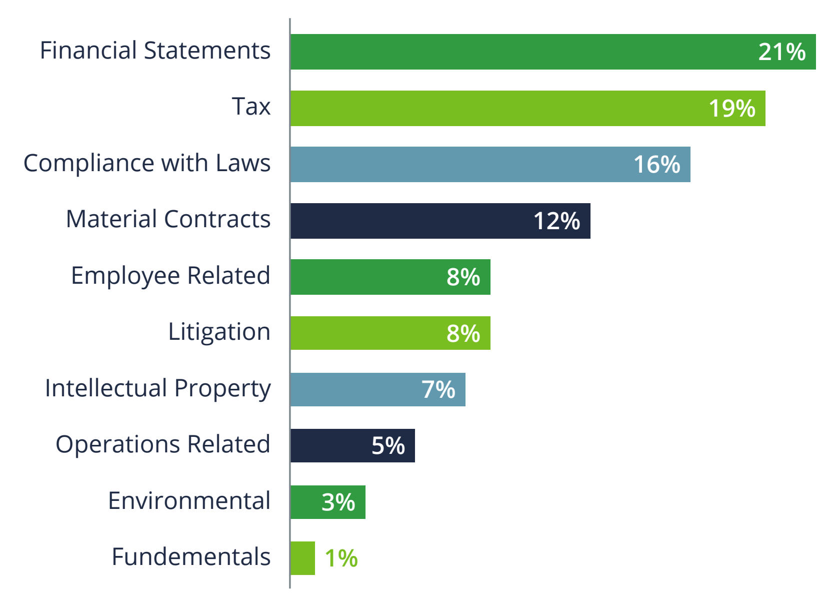
There are also similar statistics on what triggers claims.

Americas



Source: Liberty

R&W Reported Incidents by Breach — Total



Source: Liberty

Notifications continue to run about one in five policies; we know this both from the market and our own experience. In our own practice, we agree that Accounting and Financial are the most prevalent claims, followed by Tax.

The Future of RWI Claims

Getting more granular, there are also claims areas that seem to be becoming more frequent.

1. Undisclosed liabilities
2. Material contracts
3. Third-party claims

For more details on claims activity, we recommend the Lowenstein survey and both the AIG and Liberty claims reviews.

Choosing a Specialty Broker

R&W Insurance has been around in various forms for several years, both in Europe and the US. However, in the last five years, we have seen a major shift in its use and format. It is essentially a new but no longer emerging product.

This is true both in terms of the product itself and the markets that write it. Four years ago, there were six long-term, stable markets that wrote R&W in the US. Today, there are 24, and each market is different.

What to Look For… and Watch Out For

- When picking an underwriter, terms and conditions and pricing matter, but also look out for the makeup of the team. Do they have insurance professionals as well as those with M&A experience?
- Does the underwriter manage a general agency?
- How long has it been underwriting?
- How committed is the underwriter to this space?
- How does the agency or underwriter handle claims, and what experience does it have with claims to date?

It's important to remember that some of this applies to brokers, which will help you pick the most appropriate market for your risk. Many brokers are new to this product or only handle it occasionally and don't have tenured relationships with the underwriting markets or depth of experience with the product.

Beware the "boutique broker" who only focuses on reps and places no other lines of coverage. Because reps and warranties interrelates with all the company's insurance lines, all those coverages need to be reviewed by experts. You may need to put other insurance in place, so it's important to have a broker who can handle all aspects of your situation.

Here at Woodruff Sawyer, we believe that clients are best served by having a team dedicated to reps and warranties day in and day out, with access to broader resources that can review all your organization's insurance needs and present a holistic solution.

> Reps & warranties insurance is a complex and fast-growing marketplace. It requires a dedicated insurance broker who understands this type of coverage and is backed by the resources to handle all insurance lines and questions that come out of a transaction

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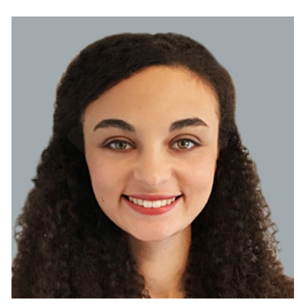

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Additional Resources

2022 PRIVATE EQUITY & M&A *LOOKING AHEAD GUIDE*

MERGERS & ACQUISITIONS BLOG SERIES

D&O NOTEBOOK BLOG SERIES

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