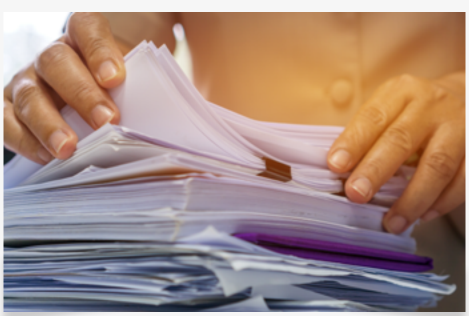
CRC Group
Wholesale & Specialty

Representations & Warranties Coverage Protects M&A Deals

The representations and warranties put forth by a seller are critical components of business mergers and acquisitions (M&A). In a traditional M&A transaction, the seller agrees to indemnify the buyer for a set period of time against breaches of their representations and warranties. The indemnity is often backed by an escrowed portion of the proceeds otherwise payable at closing. This usually amounts to around 10% to 15% of the proceeds for 1 – 2 years. However, the emerging use of representations and warranties insurance is changing or eliminating this traditional structure for many M&A deals.[1]

Fifteen years ago, many attorneys handling M&A transactions didn't see a need for representations and warranties coverage, but that recommendation has begun to shift. Organic growth has been limited for most companies over the last few years, resulting in a subsequent uptick in the volume of M&A activity as companies seek to create value through strategic mergers or acquisitions. During the first quarter of 2022, the U.S. technology services sector accounted for the largest share of U.S. M&A transactions, but M&A activity is also onthe rise in the financial arena, healthcare, and a spectrum of ot her industries across the country.[3]



Within three years of the effective date of coverage, claims were made on around 20% of representations and warranties insurance policies established between 2016 and 2018.[2]

Research shows that in 2021, there were 21,107 M&A deals - worth a total of nearly $212B - completed in the U.S. Those numbers represent an increase of almost 40% over 2020.[3] In conjunction, as M&A competition has increased, the use of representations and warranties insurance has become more popular, and the volume of coverage sold has skyrocketed. The third and fourth quarters of 2021 saw the largest number of deals ever done in the representations and warranties space. It's estimated that the coverage is now utilized in at least 30% - 35% of U.S. private transactions. The product line generated approximately $4.5B in premium in 2021 and is expected to keep growing.

The coverage has been widely utilized to protect bigger deals but remained largely unknown to many small to mid-size companies. However, the coverage is now making its way into the spotlight as macroeconomic conditions make M&A activity more common for companies of all sizes. While more small to mid-size companies have become aware of the product, they remain vastly underserved because the coverage either hasn't been offered or has been cost-prohibitive. Coverage submissions from smaller, disaggregated businesses have increased in recent years, but there's still a distinct lack of knowledge about warranties and representations coverage in the under $25M Total Enterprise Value (TEV) space, which is the most underserved transactional space in today's market.

Because the underwriting process is labor and resource-intensive, most markets invest their time in bigger deals. Much of the business has been dominated by larger retailers with dedicated M&A teams. Most of the retail base has avoided selling representations and warranties coverage because the traditional product doesn't fit well into the wholesale process due to human capital and cost constraints. However, newer streamlined, semi-automated products are starting to flip that narrative. Innovative semi-automated options mitigate underwriting costs by improving workflows and providing coverage options better suited to the small to mid-size company space. These products furnish a unique tool to help advisors, financial sponsors, and buyers facilitate healthy M&A transactions.

THE BASICS OF REPRESENTATIONS & WARRANTIES INSURANCE

Representations and warranties insurance is commonly used in corporate mergers and acquisitions to protect against losses that arise from a seller's breach of its representations during the purchase.[1] Most breaches center around inaccurate financial statements, compliance problems, material contracts, and regulatory or tax issues.

Cited in almost 20% of all claims, breach of financial statement representations is the most common representations and warranties claim.[2]

Either buyers or sellers can purchase representations and warranties coverage, but 90% of the time, the insured is the buyer, especially in today's seller's market.[1] Typically, buyers pay the premium, but it's negotiable with the insurer, and in a seller's market, premiums may be split between the buyer and the seller. Conventional representations and warranties premium ranges between 3% and 7% of purchased limits; however, the cost is much lower for semi-automated products, hovering around 2% depending on the size of the deal. The deductible is often equal to 1% - 3% of the M&A purchase price and can also be shared.[1] Coverage is generally equal to 10% - 20% of the M&A purchase price but can reach as high as 30%, with the average coverage limit hovering around 15%. The buyer often pays underwriting fees to cover tax and environmental attorneys or other specialists needed to assist with the underwriting process. Traditional representations and warranties coverage requires an underwriting fee of $35K - $55K, which can be tough for small to mid-size companies to swallow. Newer semiautomated products with low-human touch usually require much lower underwriting fees of around only $5K - $15K.

In contrast to most other financial lines, representations and warranties coverage extends back in time from the effective date of coverage. The policy term is generally 3 to 6 years, but it can be negotiated with the carrier. Three years is typically allowed for general technology, intellectual property, environmental, or healthcare representations that are often higher risk and require much more due diligence. Six years is often the chosen term for fundamental and tax representations. It's also worth noting that the underwriting process for representations and warranties varies from most financial line procedures. When a submission is received stating the limits requested and the value and timeframe of the M&A deal, a non-binding indication letter is provided before underwriting moves ahead after agreement by all parties.

KEY COVERAGE CONSIDERATIONS

Beyond the price, when considering coverage, it's also essential to determine if the seller retains liability for any breach of fundamental representations and warranties such as capitalization of the seller or if the seller will be liable for any gaps in coverage, extraordinary losses that exceed the insurance limits, or disclosed issues not covered by the policy.[1] The coverage typically excludes covenant breaches by the seller, purchase price adjustments, sanctions, or any other known issue. But, specific unique exclusions may also be applied based on underwriting due diligence.[1] Clients should also understand that while representations and warranties insurance is not an infallible alternative to traditional post-closing indemnification, escrow/holdback representations, and the warranties structure of private M&A deals, it does give the seller and the buyer another layer of comfort and security when coming to the table.[1]

REPRESENTATIONS & WARRANTIES COVERAGE BENEFITS

While brokers often receive requests from retailers seeking D&O coverage on behalf of privately held companies facing acquisition, D&O doesn't address all of the nuances of an M&A scenario. There are multiple benefits of representations and warranties insurance for both the seller and buyer in an M&A deal. Sellers' advantages can include a reduction in, or elimination of, the conventional seller's indemnity for breach of representations and warranties. It can also reduce or abolish the need for an escrow holdback that diminishes proceeds at closing, facilitate a cleaner exit with fewer contingent liabilities, and support a quicker resolution of the acquisition agreement.

Buyers benefit from first-party coverage that can make the company more attractive to sellers, especially if there are multiple bids, by lowering the escrow while still protecting the seller, potentially extending the duration of representations and warranties, allowing more time to discover problems with the acquired business. It can also likely increase the amount of protection that would otherwise be available to the buy. Because the seller typically gives more extensive representations and warranties in the acquisition agreement, it also improves the buyer's likelihood of prevailing in the event a claim is filed on the policy. In the end, both sides also benefit from a simpler, faster negotiation process because sellers are less concerned with negotiating the scope of representations.[1]

In a review of more than 600 RWI claims from 2018 - 2021, carrier losses totaled more than $850M, including retention erosions.[2]

BOTTOM LINE

Representations and warranties is still an emerging market, and it's one of the most significant growth initiatives in the insurance industry today. There's a lot of room to run, especially with smaller companies looking to exit or be acquired by a larger company. Many small to mid-size organizations are either uneducated about the coverage or assume it's not available to them based on their size. However, innovative semi-automated products are impacting the space by reducing costs and streamlining underwriting, which opens up new opportunities for retail agents to help clients through the M&A process. Navigating the nuances of the coverage can be complex, but CRC Group specializes in understanding the risks clients face. Contact your local CRC Group producer today to learn about our exclusive Insurisk Representations & Warranties product and how we can help cover your clients' M&A transactions.

Contributors

- Garrett Koehn serves as the President of Brokerage for CRC Group. His expertise focuses on professional lines, including Directors and Officers, Private Equity, Cyber, and Intellectual Property.
- Dan Lazarz is a Director of CRC Group's ExecPro Practice Group. He specializes in the effective placement of all lines of coverage within the Professional Liability, Management Liability, Healthcare, and Cyber & Data Privacy marketplace.
- Brian Hayes is Managing Partner of Fusion Americas M&A and Financial Lines, a new offering from MGA Fusion Specialty. He has amassed over 20 years of global financial lines experience and invested several years in underwriting representation and warranty insurance for complex M&A transactions.
- Nate Stortzum is Managing Partner of io.insure and has nearly 20 years of transactional, professional, and specialty lines insurance experience with both insurance companies and a large brokerage firm.

END NOTES

1. A Guide to M&A Representations and Warranties Insurance in Mergers and Acquisitions, Forbes, January 23, 2019. https://www.forbes.com/sites/allbusiness/2019/01/23/guide-mergers-acquisitions-representations-warrantiesinsurance/?sh=3742d1b367f3

2. Representations and Warranties Insurance Data and Claims, Norton Rose Fulbright, February 28, 2022. https://www.projectfinance.law/publications/2022/february/representations-and-warranties-insurance-data-and-claims/

3. Number of M&A Deals in the U.S. 2019-2021, by Deal Value, Statista, April 27, 2022. https://www.statista.com/statistics/245977/number-of-munda-deals-in-the-unitedstates/#:~:text=In%202021%2C%20there%20were%20676,dollars%20in%20the%20United%20States.