REPRESENTATION AND WARRANTIES INSURANCE

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What is Representations and Warranties Insurance?

Representations and Warranties Insurance ("RWI") is a risk allocation product that has recently received a significant amount of attention in Canada in light of its growing status as a fundamental component of M&A transactions. RWI is used primarily to protect the insured party from losses and liabilities incurred as a result of breaches of representations and warranties contained in a purchase and sale agreement. Typically, the insurance is purchased when the seller is unable to adequately indemnify the buyer or where the buyer does not have confidence in the seller's financial situation post closing. RWI thus reallocates the risk from the insured party (either buyer or seller) to the insurer by replacing or supplementing the indemnification package.

RWI has two major functions. First, RWI is a useful alternative to the traditional methods of risk allocation, the most common being indemnifications backing representations and warranties, which are in turn supported by an escrow account or a holdback arrangement against the purchase price. RWI may inject additional flexibility into the negotiation process by striking a balance between the buyer's concern for adequate protection of its investment and the seller's desire to reduce its exposure to potential liabilities and/or access the transaction proceeds earlier than if traditional methods are used. Second, as will be discussed later in detail, RWI also allows the buyer to make its bid appear more attractive and competitive to the seller while maintaining an acceptable level of risk for potential losses arising from breaches. It is important for the buyer or seller to know that it intends to use a RWI policy at the time of negotiating a bid, so that additional cost can be factored into the pricing of the deal.

It is important to keep in mind that a RWI policy can be obtained for either the buyer or the seller. Seller-side policies and buyer-side policies are purchased and structured in consideration for different motivations.

Key Aspects of a Representations and Warranties Insurance Policy

- *Coverage* – RWI policies are customized to each particular transaction and can replace or supplement escrow or holdback arrangements in the purchase and sale agreement. Coverage limits in Canadian deals are generally upwards of $50 million for any one transaction. In addition, larger policies can be arranged on a case-by-case basis; and we have seen multiple insurers collectively provide aggregate insurance of up to $300 million.

- *Duration of Coverage* – Duration of coverage differs between a buyer-side policy and a seller-side policy. While a seller-side policy generally matches the indemnity survival period in the purchase and sale agreement, a buyer-side policy can be issued for longer than the seller's survival period in order to provide the buyer a means of recourse for breaches that become apparent only after these periods have lapsed.
- *Premium and Retention* – The costs of RWI have come down in recent years as the insurance industry has become more familiar with the product and competition amongst the number of insurance companies offering RWI has increased. Currently, premiums generally range between 2–4% of the coverage limit, while retentions are typically in the range of 1-3% of the purchase price. In addition to the policy premium, insurers charge a separate underwriting fee (typically $10,000–$40,000) for due diligence and other legal costs. As the retention gets significantly larger, the premium becomes smaller and exclusions may be narrower. It is not uncommon for the premium to be shared between the buyer and seller given that both parties can benefit from implementing RWI into a transaction.
- *Exclusions* – Generally, RWI policies provide a blanket coverage. At the same time, exclusions are carved out for certain items, including breaches that that were actually known to certain individuals, fines and penalties, purchase price adjustments and forward-looking statements. A typical RWI policy will also exclude liabilities specific to the policyholder's particular situation, such as outstanding litigation or other known potential risks discovered during due diligence. It is important to note that while buyer-side policies can include coverage for seller fraud, the same cannot be said about seller-side policies. These exclusions, such as the exclusion for known breaches, can impact the negotiation of the purchase and sale agreement. For example, it changes the dynamic in the negotiation as to whether there should be a sandbagging provision included or not. If the buyer is obtaining RWI and there is no policy coverage for known breaches, there is little point for the Buyer to insist on the inclusion of "pro-sandbagging" language in the purchase and sale agreement.
- *Quick Timeline* – Obtaining RWI does not slow down the deal negotiation process nor does it require amending any existing deal documentation. The entire underwriting process for issuing a policy typically lasts from 5 to 10 days. At the same time, the insurer can act as a second set of eyes that is reviewing the transaction.
- *Legal Counsel Input* – It is important for counsel on both the seller and buyer sides to be familiar with how RWI works in order to be in a position to properly negotiate the agreement of purchase and sale. From the buyer's perspective, the buyer needs the seller to provide a full set of representations and warranties in the agreement of purchase and sale since the RWI policy insures against there being a breach of those disclosures. In private equity deals, it is not uncommon for the representations and

warranties related to operational matters to not survive closing at all, as the buyer will look to its RWI policy for its protection. It is also important for legal counsel acting on behalf of the party purchasing the RWI to understand that it will be expected to share its due diligence reports with the RWI insurance provider.

Buyer-Side Policies

Upon discovering a breach of a representation or warranty following closing, the purchaser makes claims for indemnification directly to the insurer. Circumstances in which it would be advantageous for a buyer to purchase buyer-side RWI are as follows:

- *Enhancing and Distinguishing Bids* – In an auction process, RWI can help make a bid more attractive to a seller for a number of reasons. First, it allows a buyer to accept reduced (or eliminated) escrow or holdback. Second, it allows for a lower indemnification cap as well as a shorter survival period for representations and warranties. Lastly, it shifts the risk to the insurer and provided that legal counsel is experienced in dealing with RWI in the transaction context, it can speed up the negotiation process and correspondingly reduce the legal fees for the transacting parties.
- *Acquiring Insolvent or Distressed Targets* – In such situations where a post closing indemnification that can reasonably be relied upon may be difficult to obtain from a seller, RWI can be useful as it adds a layer of protection that makes the buyer feel more comfortable with the overall risk arising from breaches of representations and warranties.
- *Multiple Sellers/Jurisdictions* – Where a buyer is purchasing assets from multiple sellers or in multiple jurisdictions, the chances of collecting on indemnity may be lowered in certain cases. RWI may be useful in such scenarios because the risk is concentrated to one insurer. The insurance would be equally helpful in situations where the buyer cannot obtain joint and several indemnifications from the seller(s).
- *Retaining Management of Sellers* – Where the management of the seller is retained by the buyer after closing, RWI may allow the buyer to avoid bringing an indemnity claim against individuals who are now members of the buyer's own management.

Seller-Side Policies

Seller-side policies are third party liability policies. While any claims by the buyer made with respect to a breach of representation or warranty are submitted to the insurer, the seller nevertheless remains liable to the buyer pursuant to the terms of the purchase and sale agreement. Circumstances in which it would be advantageous for a seller to purchase seller-side RWI are as follows:

- *Removing Contingent Liabilities* – A seller who wants to remove contingent liabilities from its balance sheet can purchase RWI to remove exposure to indemnification risk. This will serve to reduce exposure to a level that the seller is more comfortable with.

- *Multiple Sellers* – In a scenario where there are multiple sellers, there is often tension surrounding which subset of sellers should bear the risk of any indemnity claims related to breaches of representations and warranties. The use of RWI can eliminate this tension.
- *Distributing Proceeds* – RWI may allow private equity sellers to wind down funds and return the proceeds to investors more quickly after closing. RWI provides this advantage by fully or partially removing the restrictions placed on transferring the proceeds of sale by an escrow or holdback arrangement.
- *Adding Value to Transaction* – A seller who wants to add value to a transaction may use RWI to provide enhanced representations, warranties and indemnities in exchange for a higher purchase price.
- *Bridging the Gap* – Sometimes a seller will purchase the insurance policy for the buyer in an effort to bridge any gaps that arise during negotiations, including escrow amounts, indemnification clauses and/or survival periods of the representations and warranties.

Conclusion

RWI is being used increasingly in the Canadian business and legal market, especially in the context of M&A transactions. Sellers use RWI to maximize the proceeds of sale and to achieve an efficient and clean exit. Buyers use RWI to compensate for lower indemnification caps and shorter survival periods and to make their bid more competitive in auctions. In order to effectively implement and benefit from a RWI policy, those considering to purchase a RWI policy should negotiate carefully with the insurer essential policy terms, including the coverage amount, policy period, premium, retention, loss definition and exclusions. Having a strong understanding of RWI will thus strengthen your client's position over the course of negotiations as well as make you a more valued advisor to your client.

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A Cautionary Note